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# Chapter VI

## Competition in the Financial Markets

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1. Introduction
  2. The financial markets
  3. Systemic relevance and systemic stability
  4. The three-pillar structure of the German banking system
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## Chapter VI – Competition on the financial markets

### 1 Introduction

**1329.** Financial markets are at the centre of interest of both economic policy and of the public. The discussion focuses on the economic and “moral” responsibility of the financial sector for the financial and economic crisis in Europe and on the potential for politicians to avoid future crises. The governing coalition in Germany stipulated in the coalition agreement for the current legislative period that clear boundaries have to be set on speculation, that taxpayers would not be burdened with the financial sector’s risks, and that no financial market actors, no financial product or market should remain without adequate regulation.<sup>1</sup>

**1330.** In this special chapter, the Monopolies Commission analyses the development and the regulation of financial markets since the outbreak of the crisis. The German public debate on the financial crisis and its consequences revolves primarily around questions of financial market stability and around moral questions of fault and punishment. However, in accordance with its mandate, the Monopolies Commission comments on matters of competition policy only, and thus has nothing to say on the responsibility of market participants for past aberrations. The Monopolies Commission’s comments are also made within the limits of a legal framework provided by European and German competition law. Within this framework, regulation and law enforcement on the financial markets must be shaped in a way as to further, and not impede, the creation of a European single market where competition is not distorted.<sup>2</sup>

**1331.** In the first section of this chapter, the Monopolies Commission provides an outline of the financial markets and the relevant regulatory context, and includes an assessment produced for the German Council of Economic Experts and the Monopolies Commission. The second section focuses on the systemic distortions of competition favouring banks and shadow banks<sup>3</sup> disposing of implicit State guarantees. In this context, the Monopolies Commission evaluates the re-regulation of the financial markets addressed in the coalition agreement, on the basis of the competition-related policy goals of the European Treaties.<sup>4</sup> In the third section, the Monopolies Commission describes the competitive distortions favouring certain groups of banks within the three-pillar structure of the German banking sector.<sup>5</sup> In the final section, the Monopolies Commission comments on current competition problems at the level of financial products and transactions, for instance, with respect to

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<sup>1</sup> CDU, CSU and SPD, Coalition Agreement, 18<sup>th</sup> Legislative Period, published on 27 November 2013, p. 62.

<sup>2</sup> See, particularly, Article 3(3)(1) EUV, Articles. 101 ff. TFEU, Protocol No. 27 to the Treaties, OJ C 115, 9 May 2008, p. 309. The German Basic Law (*Grundgesetz*) does not contain comparable provisions on the economy.

<sup>3</sup> In this Report, the term “banks” is used for credit institutions (including savings banks), the term “shadow banks” for non-banks engaging in forms of credit intermediation.

<sup>4</sup> As to systemic issues, see already previously Monopolies Commission, XV<sup>th</sup> Main Report 2002/2003, Competition Policy Under Shadow of “National Champions”, Baden-Baden 2004, paras. 1 ff. (competition and industrial policy), and there particularly paras. 13 ff.; XVIII<sup>th</sup> Main Report 2008/2009, More Competition, Few Exceptions, Baden-Baden 2010, paras. 324 ff.; and the Special Reports No. 26, Regulative Guidance for a Functioning Financial System, Baden-Baden 1998, and No. 27, System Competition, Baden-Baden 1998.

<sup>5</sup> As to the structure of the German banking system, see already Monopolies Commission, I<sup>st</sup> Main Report 1973/1975, More Competition is Possible, Baden-Baden 1976, pp. 191 ff.; II<sup>nd</sup> Main Report 1976/1977, Increasing Concentration at Large Companies, Baden-Baden 1978, paras. 101 ff., 495 ff.; IV<sup>th</sup> Main Report 1980/1981, Progress at the Measurement of Concentration, Baden-Baden 1982, paras. 872 ff.; IX<sup>th</sup> Main Report 1990/1991, Competition Policy Versus Industrial Policy, Baden-Baden 1992, para. 52; XI<sup>th</sup> Main Report 1994/1995, Competition Policy in Times of Change, Baden-Baden 1996, paras. 109 ff.; XII<sup>th</sup> Main Report 1996/1997, Opening Up Markets Extensively, Baden-Baden 1998, paras. 53 ff.; XIII<sup>th</sup> Main Report 1998/1999, Competition Policy in Network Structures, Baden-Baden 2000, paras. 122 ff.; as well as the Concentration Reporting in the Main Reports.

the current allegations of manipulation levelled against large (also German) banks and on continuing problems relating to the current account and payments businesses (relating, e.g., to credit card and cash-machine fees).<sup>6</sup> The Monopolies Commission confines its recommendations to how the objective of undistorted competition, according to its point of view, can best be achieved.

**1332.** The Monopolies Commission welcomes the willingness of the German political protagonists to work towards the elimination of existing competitive distortions on the financial markets. It encourages politicians to equally and actively support the enforcement of competition rules in relation to existing structures, products and types of transactions on the financial markets, and to ensure improvement of market conditions where market participants (including consumers) are at a structural disadvantage.

## ***2 The financial markets***

### ***2.1 Functions***

**1333.** The main remit of the financial markets consists in coordinating the supply and demand of capital as well as efficiently allocating capital. In order to match supply and demand of capital, financial markets fulfil three important transformational functions: lot size, maturity and risk transformation.<sup>7</sup> Lot size transformation takes place to accommodate the different intentions of capital investors and acquirers of capital as to the amounts to be traded. Maturity transformation leads to the equation of different periods of time for which market participants want to invest or acquire capital. Risk transformation finally harmonises different risk preferences of capital investors and acquirers of capital. Alongside these functions, payment services central to the economy are processed through the financial markets.

**1334.** The mentioned functions are carried out by a multitude of financial intermediaries. Besides credit institutions in the traditional sense, these include players which today are readily subsumed under the concept of shadow banking, such as venture capital companies, hedge funds and insurance companies, to name but a few.<sup>8</sup> Depending on the relative importance of the respective financial intermediaries within a financial system, it can be classified as bank-based or (financial) market-based.

**1335.** Financial intermediaries decisively contribute to the growth of an economy as a whole by the identification and funding of innovative and promising projects as well as by the assumption of risks. The macroeconomic significance of financial markets, thus, is not limited to their direct share of the aggregate value added, which for Germany was 4% in 2013, but in addition encompasses the indirect contribution to the growth of the so-called real economy due to the efficient allocation of capital. The importance of the financial system for the real economy was most recently revealed by the financial crisis, when the distortions on the financial markets caused, among others, a decrease of the gross domestic product in 2009 of 5.1%, adjusted for price.

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<sup>6</sup> Regarding this issue, see Monopolies Commission, XVIIth Main Report 2006/2007, Less State, More Competition, Baden-Baden 2008, paras. 918 ff.; XIXth Main Report 2010/2011, Strengthening Competition in Retailing and Services, Baden-Baden 2012, paras. 594 ff.

<sup>7</sup> Cf. Hartmann-Wendels, T./Pfungsten, A./Weber, M., *Bankbetriebslehre*, 5th Ed., Berlin/Heidelberg 2010, pp. 4-10.

<sup>8</sup> In contrast to these market participants, however, banks also have a central function in that they create money by supplying credit.

## 2.2 The banking systems

### 2.2.1 The German banking system

**1336.** Germany's financial system is mainly banking-based; that is, banks play an unequally more important role in the allocation of capital than do capital markets. Financial market actors such as insurance companies, venture capital companies, hedge funds, etc., in this respect play only a secondary role in Germany. Accordingly, the external financing of German business takes place mainly through bank lending, while only few and larger companies issue bonds.

A specific feature of the German banking system is the so-called house bank principle ("*Hausbankprinzip*"), according to which the business relationship between banks and their customers is established for the long term. Such long-term business relationships minimise information asymmetries and enable banks to better assess their debtors' situation, and arguably to maintain the business relationship even in times of crisis. Particularly during the last financial crisis, this principle had a stabilising effect on the German economy by contributing to secure lending for German businesses.

Nonetheless, sometimes the underdevelopment of the German capital market and the concomitant dependence of the German economy on banks gives rise to criticism. Measures to further capital markets have been called for again and again for the same reason. As a matter of principle, the coexistence of bank and capital market financing seems reasonable, not least in order to secure external financing for German business also in crises that mainly affect traditional banking.

#### Structure

**1337.** The German banking system, due to its structure, is also called a "three pillar system", within which institutes normally are assigned to three groups, according to their legal form. In this three pillar structure, private commercial banks constitute the first, the public banks the second and cooperative banks the third pillar.<sup>9</sup> These three pillars may be outlined as follows:

- The private banks have a private legal form (mainly stock company) and mostly do business as universal banks. The private banks encompass four major or "large banks" (*Großbanken*) (Commerzbank AG, Deutsche Bank AG, Deutsche Postbank AG, UniCredit Bank AG) as well as the groups of private regional banks and of small private banks, whose numbers have been dwindling over the years. Also in this pillar are included the subsidiaries and branches of foreign banks and so-called real credit institutions, for example, the private mortgage banks.
- The public banks are mainly established as public-law institutions and are meant to fulfil a public mandate. This group encompasses in particular the savings banks financial group (*Sparkassen-Finanzgruppe*: savings banks, *Landesbanken* and special banks such as the building societies of the Länder (*Landesbausparkassen*)). Furthermore, the public banks with special missions (*Banken mit Sonderaufgaben*) can, at least from a competition point of view, be counted in this group, in particular the public development banks (e.g., the KfW banking group). The activities of the public banks are in most cases restricted by law – for instance, the savings banks may mainly or exclusively do business within the territory of their controlling entity (regional principle (*Regionalprinzip*)).
- The cooperative banks, due to their particular legal form, compose a third group within the German banking system. Registered cooperatives are marked by the issuance of (at least

<sup>9</sup> Cf extensively Council of Economic Experts (Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung), Das deutsche Finanzsystem: Effizienz steigern – Stabilität erhöhen, Expertise of 17 June 2008, paras. 140 ff.

three) shares, the voting rights being personal and independent of the amount invested (“one man – one vote”). Among the cooperative banks are the cooperative financial group (VR-banks, WGZ-bank, DZ-bank and their respective subsidiaries, for example, the building society Schwäbisch-Hall) as well as Sparda-banks, PSD banks, ecclesiastical banks and further special banks. The VR-banks, too, observe the regional principle, which, however, does not legally bind them.

**1338.** The commercial banks of the particular banking groups differ not only as to their legal form, but, particularly, also as to their business models. An aggregate view of assets and liabilities of the respective types of bank for the period of 1993–2012 most notably shows articulate differences between small and larger banks.<sup>10</sup> Small banks (savings and cooperative banks, but also regional banks), according to this, finance their business particularly on the basis of their customers’ deposits, which they bundle and pass on as credits to other customers. In contrast, the business models of larger banks encompass capital market activities to a larger extent. Here, the portfolio of the major banks is particularly diversified, which finance their business in large part also on the basis of deposits, but besides also on the basis of interbank lending and trading activities. They mainly issue consumer, business and interbank loans, but are also extensively active in commercial transactions. The *Landesbanken* finance their business mainly on the basis of interbank loans, capital market activities and customer deposits, and issue mainly consumer, business and interbank loans. To the two cooperative central banks, interbank loans are most important both as a source and for the use of funds, due to their function as the central banks of the cooperative banking sector.

**1339.** The German banking system, as measured by the aggregate balance sheet total, has substantially grown over the past two decades. While the aggregate balance sheet total of all banks in Germany (excluding the Bundesbank and money market funds) at the end of 1990 amounted to EUR 2,681 billion, this figure, after a transitory peak of EUR 8,467 billion in 2011, reached EUR 7,604 billion at the end of 2013.<sup>11</sup> Thus, the aggregate balance sheet total in 2013 corresponded to roughly 2.8 times the German GDP, in contrast to just double in 1990. The sharp rise in the German banking system’s aggregate balance sheet total since the 1990s mainly goes back to an expansion of the large private banks, which could substantially gain market shares from the savings and mortgage banks.

Measured by the aggregate balance sheet total, the credit banks (private banks) with a common market share of 36.39% today constitute the largest group within the German banking sector. Among these, the four large banks account for 22.62%, the regional and other credit banks for 10.73% and the branches of foreign banks for 3.03%.<sup>12</sup> The group governed by public law, consisting of savings banks (14.61%) and *Landesbanken* (14.37%), amounts to a market share of roughly 29%, the cooperative group consisting of credit cooperatives (10.02%) and the two cooperative central banks (3.59%) approximately 13.6%. In addition to these banks, there exist mortgage banks (5.85%), building societies (2.70%) as well as banks with special missions (12.48%), encompassing in particular the development banks.

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<sup>10</sup> Concerning the following, cf. Koetter, M., Market Structure and Competition in German Banking, Gutachten im Auftrag des Sachverständigenrats und der Monopolkommission, 11 February 2014, pp. 14 ff.

<sup>11</sup> Deutsche Bundesbank, Makroökonomische Zeitreihen, time line No. BBK01.OU0308: Bilanzsumme (until Dec. 1998: Geschäftsvolumen)/Alle Bankengruppen; [http://www.bundesbank.de/Navigation/DE/Statistiken/Zeitreihen\\_Datenbanken/Makrooekonomische\\_Zeitreihen/its\\_list\\_node.html?listId=www\\_s100\\_mb2425\\_1\\_02](http://www.bundesbank.de/Navigation/DE/Statistiken/Zeitreihen_Datenbanken/Makrooekonomische_Zeitreihen/its_list_node.html?listId=www_s100_mb2425_1_02); accessed: 24 June 2014.

<sup>12</sup> Cf. Deutsche Bundesbank, Bankenstatistik April 2014, pp. 10 ff. The market shares above relate to the data that the Deutsche Bundesbank lists in the bank statistics (*Bankenstatistik*). Other market shares can result in particular if banks with special tasks (*Banken mit Sonderaufgaben*) are not considered or allocated to the pillar of public banks.

**1340.** During the past two decades, an appreciable consolidation has taken place in the German banking sector, which, due to the strict separation of the three pillars, primarily occurred not comprehensively, but within each of the pillars. Across all banking groups, the number of banks reporting to the Bundesbank diminished from the end of 1990 to the end of 2013 from 4,638 to 1,846 or by roughly 60%, although this process of consolidation has slowed down in recent times. The declining number of banks mainly goes back to mergers within the savings and the cooperative banking sectors.<sup>13</sup>

Beside the number of banks, the number of branch offices has also considerably decreased. While the banks were operating a total of 67,930 branches in 1995, in 2012 only 36,283 branch offices existed. This corresponds to a decline of 46.6%. In this respect, one can observe that this reduction of domestic branch offices has accelerated in the most recent past. Just in 2012, the number of branch offices decreased by 1,436 or 3.8% in comparison to 2011, following a previous decrease by 1.2% in comparison to 2010. The latest reduction of branch offices is mainly imputable to the credit banks, which in 2012 thinned out their network of branch offices by 1,115 branch offices (10.4%). In the same period, savings and cooperative banks, with 179 and 160 branch offices, only cut back 1.3% respectively, and continue to have the densest geographic branch office presence. In 2012, savings banks were operating 13,094, cooperative banks 11,789 and credit banks 9,637 branch offices.<sup>14</sup>

**1341.** The declining number of banks has led to an increase in the average size of German banks as well as to higher market concentration. Still, the German banking system remains heavily fragmented as compared with international standards. This is illustrated by common concentration measures such as the CR5, which measures the cumulative market share of the five largest banks of a country by balance sheet total, or the Herfindahl-Hirschmann Index (HHI), which specifies the sum of the squared market shares of all banks. In 2012, the concentration of the German banking system continued to be the lowest within the EU-27 with a cumulative market share of the five largest banks of 33% and an HHI of 307.<sup>15</sup>

This low concentration can be attributed to savings and cooperative banks with partly very low balance sheet totals. Thus, if one looks at the aforementioned concentration measures alternatively for regional markets, one sees unequally higher concentration ratios. The cumulative market share of the five largest banks, at the level of so-called regional planning areas, amounts to approximately 73 percent, with an HHI of approximately 2,100. Here, both indicators have risen sharply since 1993, due to the growing banking sector and the decrease in the number of banks. Looking at the regional distribution of market concentration measures, one can detect a Northeast-Southwest differential, with the highest market concentration in the Northeast of Germany.<sup>16</sup>

### *Profitability*

**1342.** The German banking sector, in international comparison, is regarded as relatively unprofitable, which is mainly imputed to weak earnings. On the cost side, German banks were attested a relatively high cost efficiency for some time; only more recent disaggregated surveys paint a more unfavourable

<sup>13</sup> Cf. Deutsche Bundesbank, Makroökonomische Zeitreihen, Anzahl der berichtenden Institute; accessible: [http://www.bundesbank.de/Navigation/DE/Statistiken/Zeitreihen\\_Datenbanken/Makrooekonomische\\_Zeitreihe/its\\_list\\_node.html?listId=www\\_s100\\_mb2425\\_1\\_01](http://www.bundesbank.de/Navigation/DE/Statistiken/Zeitreihen_Datenbanken/Makrooekonomische_Zeitreihe/its_list_node.html?listId=www_s100_mb2425_1_01); accessed on 24 June 2014.

<sup>14</sup> Cf. Deutsche Bundesbank, Bankstellenbericht 2012. Entwicklung des Bankstellennetzes im Jahr 2012, 30 August 2013.

<sup>15</sup> Cf. ECB, Structural Indicators for the EU Banking Sector, 2013; [http://www.ecb.europa.eu/stats/pdf/130708\\_ssi\\_table.pdf?6eb6a27bf4fc505cee66a57a5c20d02f](http://www.ecb.europa.eu/stats/pdf/130708_ssi_table.pdf?6eb6a27bf4fc505cee66a57a5c20d02f); accessed on 24 June 2014.

<sup>16</sup> Cf. Koetter, M., Market Structure and Competition in German Banking, supra (fn. 10), pp. 33 ff.

picture in this respect. Yet, independently from the cost side, the low profitability should be mainly attributable to weak earnings.<sup>17</sup>

**1343.** This – compared with international standards – poor earnings situation of German banks traditionally shows in a higher than average cost–income ratio and in a low return on equity.<sup>18</sup> The cost–income ratio, which relates administration costs to gross profit (respectively to operating earnings), was in 2012 for German banks above the median of the euro area, and has even declined since 2008.<sup>19</sup> Its average across all banks in 2012 was at 68.9% (64.2%), up from 66.4% (63.7%) in 2010.<sup>20</sup> Savings and cooperative banks, on the basis of gross profit, showed a clearly better cost–income ratio than large banks. Considering operating earnings, the difference was much smaller, particularly since the large banks could significantly improve their cost–income ratios from 2010 to 2012, while those of savings and cooperative banks deteriorated.

**1344.** A look at the net interest and commission incomes, which underlie the cost-income ratio, makes clear the poor result situation. The interest profits as the most important source of income of German banks has been declining since the early 1990s, and in 2012 reached a record low of 0.99 percent on average across all banking groups. Since the financial crisis only the savings and cooperative banks, which traditionally generate the highest interest margins, managed to improve their results and in 2012 obtained interest margins of 2.12% and 2.21% respectively, followed by the private regional banks and other credit banks (1.51%). An interest margin below average was attained by the large banks (0.68%), the *Landesbanken* (0.63%), and the cooperative central banks (0.48%).

Net commission income as the second most important source of income has also been declining for years. It went down from 0.39% in 2006 to 0.30% in 2012 across all banking groups. A net commission income traditionally above average is generated by the regional banks (0.61%) and the savings and cooperative banks (0.56%). The large private banks, in contrast with earlier years, attained a net commission income, only slightly above average, of 0.32%.<sup>21</sup>

**1345.** The return on equity as further measure of profitability in 2012 lay at 7.80% before taxes across all banks and thus – in consequence to the financial crisis and in comparison with earlier years – was above the European average of 4.9%<sup>22</sup>; a relatively high return on equity was as in earlier years generated by the savings and cooperative banks with 12.96% and 15.71%. The large banks with 6.08% attained their best figure since 2007. Over time, the return on equity of large banks is much more volatile than that of savings and cooperative banks as a consequence of their business model.

### *Competition in the German banking sector*

**1346.** The low profitability of German banks is often traced back to a particularly high intensity of competition in Germany, which supposedly is manifested in a low concentration of the banking sector. Concentration measures based on market shares such as the aforementioned CR ratio and the Herfindahl-Hirschmann index however are only of little use in measuring competition; first, because market shares as such allow at best for a raw approximation of the actual intensity of competition; second, because the competition in banking takes place mainly in regional markets and on product level, particularly so in Germany on the basis of the regional principle to which most savings and cooperative banks conform. Thus, if such measures are to be used at all, they should be determined on

<sup>17</sup> Cf. Council of Economic Experts, *Das deutsche Finanzsystem: Effizienz steigern – Stabilität erhöhen*, supra (fn. 9), paras. 158 ff.

<sup>18</sup> Cf. *ibid.*, para. 158.

<sup>19</sup> Cf. ECB, *Banking Structures Report*, November 2013, p. 25.

<sup>20</sup> Cf. Deutsche Bundesbank, *Die Ertragslage der deutschen Kreditinstitute*, supra.

<sup>21</sup> Cf. Deutsche Bundesbank, *Monatsbericht* September 2013, p. 35.

<sup>22</sup> Cf. Bain & Company, *European banking: Striking the right balance between risk and return*, study published on 17 July 2013, p. 8; Deutsche Bundesbank, *Die Ertragslage der deutschen Kreditinstitute*, supra.

a regional level. As far as this is concerned, a particularly low concentration – by international standards – of the German banking system by international standards does not as such imply a greater intensity of competition.

**1347.** Empirical measures, such as the Lerner index, the h-statistic or the Boone indicator are more suitable for determining the intensity of competition. International surveys based on these competition measures have found an intensity of competition for the German banking sector in the past which was only, if at all, marginally greater than average.<sup>23</sup> In addition, more recent surveys tend to point to a decreasing intensity of competition in the German banking sector since the early 2000s, as measured by an increase in the Lerner index.<sup>24</sup> Koetter (2014), for instance, measures a Lerner index of 39 percent for the entire German banking sector during the period from 1993 to 2012. He shows this index to have markedly increased from a relatively stable level of around 36% to 38% from the 1990s to 2006 to 43%, and that it reached a new high at roughly 47% in 2011 after a short setback at the early stages of the financial crisis. This latest increase here is attributed mainly to central bank activities in response to the crisis.<sup>25</sup>

**1348.** Surveys looking at the intensity of competition separately by types of bank, in contrast, come to partially quite diverse results. Hempell (2002) in this respect shows, on the basis of the h-statistic for the period from 1993 to 1998, that large banks and particularly foreign and credit banks tend to be much more exposed to competitive pressure than small and medium banks, respectively savings and cooperative banks.<sup>26</sup> Gischer/Thiele (2004) confirm the lower intensity of competition in the savings banks sector for the period from 1993 to 2002, and furthermore show that smaller banks are exposed to an even lower intensity of competition than larger banks.<sup>27</sup> Kick/Prieto (2013), on the basis of the Lerner index for the period from 1994 to 2010, show that particularly small private banks, but also savings and cooperative banks have the greatest market power virtually over the entire observation period. Additionally, it becomes apparent that the Lerner index of the savings and cooperative banks shows the least variability over the years. Private large banks, in contrast, not only show the highest variability, but tend also to have the lowest Lerner index, even if this latter has increased over the observation period.<sup>28</sup>

**1349.** In clear contrast to this are the results of Koetter (2014).<sup>29</sup> Indeed, here it is first established that savings and cooperative banks, during the observation period from 1993 to 2012, generated substantially higher price-cost margins than other commercial banks.<sup>30</sup> The analysis by means of the Lerner index, which better depicts banks market power, however shows a greater market power of larger banks.<sup>31</sup> The highest Lerner index here is observed for the four large banks (76%), while

<sup>23</sup> Cf. Council of Economic Experts, *Das deutsche Finanzsystem: Effizienz steigern – Stabilität erhöhen*, supra (fn. 9), paras. 158 ff.

<sup>24</sup> Cf. Kick, T./Prieto, E., *Bank Risk Taking and Competition: Evidence from Regional Banking Markets*, Deutsche Bundesbank Discussion Paper No 30/2013; Koetter, *Market Structure and Competition in German Banking*, supra (fn. 10), pp. 46 ff. In addition, this study measures competition in the German banking sector based on the Boone Indicator and the h-statistic. Whereas the h-statistic confirms the results of the Lerner Index, i.e., increasing market power, the Boone indicator points to decreasing market power.

<sup>25</sup> Cf. Koetter, *Market Structure and Competition in German Banking*, supra (fn. 10), pp. 51 ff.

<sup>26</sup> Cf. Hempell, H.S., *Testing for Competition Among German Banks*, Deutsche Bundesbank Discussion Paper 04/02, January 2002.

<sup>27</sup> Cf. Gischer, H./Stiele, M., *Testing for Banking Competition in Germany: Evidence from Savings Banks*, FEMM Working Paper Series No. 20/2005, 2005.

<sup>28</sup> Cf. Kick, T./Prieto, E., *Bank Risk Taking and Competition: Evidence from Regional Banking Markets*, supra.

<sup>29</sup> As to the following, cf. Koetter, M., *Market Structure and Competition in German Banking*, supra (fn. 10).

<sup>30</sup> Price-cost margins are here defined as the difference between interest earned and interest paid, each in relation to the respective interest-bearing business operations. In contrast, the term “interest margin” denotes the differential between interest earned and interest paid in relation to the average balance sheet total.

<sup>31</sup> The diverging results of Kick/Prieto (2013) and Koetter (2014) should be a consequence of particularly the

savings banks (40%) and cooperative banks (37%) show the lowest figures. In this context, an increase of market power can be observed from 1993 to the outbreak of the financial crisis in particular for the large banks and the *Landesbanken* as well as, since the turn of the millennium, for the cooperative and mortgage banks. Additionally it is shown that the market power of banks decisively depends on factors of the business model pursued. According to this survey, among others a specialised credit portfolio, a smaller network of branch offices and a lower dependence on funding on the basis of deposits and on trading activities have a positive effect on the Lerner index. Furthermore, the market power of banks is amplified by a larger balance sheet total, a higher return on equity as well as a larger share of customer credits and off-balance sheet activities, while it is alleviated, among others, by larger liquidity buffers.

Not least, this survey illustrates that the intensity of competition differs quite considerably between the different German regions, and that banks have more market power in the North-East than in the South-West. This is shown by the regional distribution both of the price-cost margins and of the Lerner index. The survey thus focuses attention on to regional market and economic factors, and shows that banks' market power is amplified, among others, by a higher cumulative market share of the local three largest banks (CR3), a larger interest spread, a higher per capita income as well as local restructuring mergers. In contrast, higher regional economic growth has a positive effect on the intensity of competition.

**1350.** These results, on the one hand, illustrate the problems of evaluating the intensity of competition on the basis of econometric methods. On the other hand, they show that competition in the banking sector is contingent on many factors relating both to the business model of banks and to regional market and economic factors. Since competition in the banking sector takes place in particular on regional markets and can vary considerably within national economies, international comparisons of the intensity of competition within national banking systems should be interpreted with caution. In order to evaluate the factual intensity of competition in particular markets, however, the definition of the relevant product and geographic markets, as undertaken by competition authorities, is indispensable. In this respect the Federal Cartel Office (FCO), for instance, differentiates between the private, business and corporate customers' segments and discerns markets for current accounts, deposits and credits. In addition, the geographic markets are mostly defined as regional.<sup>32</sup> The fact that mergers are regularly prohibited on such basis again illustrates the mainly regional orientation of banking competition – particularly in Germany.

### ***General appraisal of competition in the banking sector***

**1351.** There is commonly a preference for as much intense competition as possible on the markets because effective competition allows for an efficient allocation of scarce resources and, thus, contributes to the most cost-efficient production possible. In addition, intense competition furthers the dynamic efficiency of the markets by making companies innovative on an ongoing basis. On the financial markets, however, these positive effects of competition are somewhat controversial given the potential of negative repercussions on financial stability. At the core, theoretical economic literature breaks down into two factions regarding the relationship between competition and stability in the banking sector: one assuming a destabilising effect of competition and another presuming stabilising effects.<sup>33</sup>

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differing econometric estimation methods (Stochastic Single Frontier Model vs. Latent Class Stochastic Frontier Model), the fact that Koetter (2014) includes mortgage banks, and differing survey periods.

<sup>32</sup> Cf., e.g., FCO, Decision of 28. February 2012, B4-51/11.

<sup>33</sup> An overview of relevant literature can be found in Beck, T., Bank Competition and Financial Stability: Friends or Foes?, World Bank, WPS4656, June 2008.

**1352.** The critics of intense competition point in particular to the possibility that less intense competition could discipline banks in their risk acceptance behaviour as the expectation of future profits would set incentives to avoid bankruptcy.<sup>34</sup> In contrast, more competitive pressure accompanied by lower profits could induce banks to accept higher risks. Also, more intense competition could shorten the financial relations between companies and banks and reduce the incentives for banks to invest in thorough company assessments. This would lead to the result of inefficient bank loan supply and a rise in credit default risks.<sup>35</sup>

The proponents of intense competition, in contrast, claim that bank customers could react to the increased funding costs due to lower bank competition by accepting more risks themselves and by choosing riskier investment strategies. In contrast, the decreased interest burden of more intense competition would result in safer investment strategies and, thus, to a lower risk of credit default for the bank.<sup>36</sup> Hence, all things seen together, more intense competition would have a positive effect on systemic stability.

**1353.** Similar to theory, empirical research does not produce clear results as concerns the relationship between competition and stability, though a tendency towards a positive relationship can be discerned – contrary to earlier assumptions.<sup>37</sup> Indications in this direction can be derived particularly from cross-border studies whereas the results of country-specific studies are not totally clear. The varying results are mainly attributed to the consideration of different regulatory conditions in the cross-border studies.<sup>38</sup>

A principal result of empirical literature is that banking systems fraught with more restraints on competition are more susceptible to banking crises. In addition, it shows once again how important the distinction is between concentration and competition ratios. Beside higher intensity of competition, also higher market concentration can have positive effects on the stability of the banking system as long as it is associated with higher diversification of risks.

**1354.** All in all, it must be stated that competition is not bad for the stability of the banking sector as such, but to the contrary that measures restraining competition can result in risks for stability. However, a functioning regulatory framework and effective supervision constitute the precondition for effective competition in the banking sector. In contrast, disruptions like the ones becoming apparent in the most recent financial crisis point to a flawed regulatory framework and, along with that, to competition issues. In that regard, it is an essential task of banking regulation to establish market-economy and efficiency enhancing processes in the financial system, making it possible, for example, that failed banks – regardless of their size – can leave the market at any time.

## ***2.2.2 European banking and financial systems***

**1355.** In the European Union, more bank-based financial systems stand alongside more market-based systems. Given this circumstance, when one analyses the European financial systems, it is necessary to consider particularly the connection between banking systems and regulated markets. In this

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<sup>34</sup> Cf., e.g., Keeley, M.C., Deposit Insurance, Risk and Market Power in Banking, *American Economic Review* 80, 1990, pp. 1183-1200.

<sup>35</sup> Cf., e.g., Allen, F./Gale, D., Competition and Financial Stability, *Journal of Money, Credit, and Banking* 36(3) Pt. 2, 2004, pp. 453-480.

<sup>36</sup> Cf., e.g., Boyd, J.H./De Nicoló, G., The Theory of Bank Risk Taking and Competition Revisited, *Journal of Finance* 60(3), 2005, pp. 1329-1343.

<sup>37</sup> Cf. Beck, T., Bank Competition and Financial Stability: Friends or Foes?, *supra*.

<sup>38</sup> See, among others, Beck, T./De Jonghe, O./Schepens, G., Bank Competition and Stability: Cross-Country Heterogeneity, [2013] *Journal of Financial Intermediation* 22(2), pp. 218-244.

regard, the Middle and Eastern European States (MOE States) have frequently pursued a special path after the opening up of the former Eastern Bloc.<sup>39</sup>

### *The evolution of the European banking systems*

**1356.** Originally, large differences existed between the European banking systems. Classic universal banking systems (e.g., in Germany, Italy) existed alongside quite distinct dual banking systems (e.g., in France, the United Kingdom). Already in the two decades preceding the financial crisis, however, great changes took place in the European landscape of banking in that major banks developed in many Member States and there was strong consolidation. For example, in the EU-15 States, the number of credit institutions dropped by 27% in the period from 1995 to 2004.<sup>40</sup> This consolidation also affected savings and cooperative banks. In many Member States, smaller credit institutions saw themselves driven into niches or had to vanish from the market completely. The structure of the German banking system with its three-pillar structure remained stable despite this consolidation, which was exceptional.<sup>41</sup>

**1357.** The consolidation of the landscape of European banking is still not over. In its development so far, it is considered as insufficient by experts, regulators, and even many market participants. In most cases, consolidation took place in an uncoordinated fashion and moreover had a defensive thrust in many Member States (defensive and rescue mergers). This implies that it did not necessarily lead to stable market structures. On some national universal banking markets already marked by overcapacity, “national champions” developed instead (e.g., in France, Spain). This development was accompanied by the rise of oligopolies particularly in the economies strongly relying on the financial sector (particularly, the UK, Ireland but with comparable developments in the Scandinavian countries).<sup>42</sup> Continental European politicians supported the development of “national champions” even actively in many cases, be it to further the establishment of internationally competitive market players or for fear of foreign takeovers. Such tendencies also existed in Germany for a certain time. From a competition perspective, they had always to be judged critically.<sup>43</sup>

**1358.** In some smaller Member States, the development of major banks and the strong reliance on the financial sector had as a result that the domestically active institutions and other financial market organisms (e.g. funds) controlled more and more assets to the extent that the financial sector has become a central factor in the national economy (e.g., in the Netherlands, Belgium), which partly even exceeded considerably the size of the national economy (e.g., in Luxembourg, Cyprus). In the former Eastern Bloc countries, highly concentrated markets evolved which have since been dominated by foreign institutions.

**1359.** Altogether, however, the banking sector remained very heterogeneous before the financial crisis.<sup>44</sup> In Austria, France, Germany, Italy, Luxembourg, and also the UK, the market share of the five

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<sup>39</sup> Cf. Bijlsma, M.J./Zwart, G.T.J., *The Changing Landscape of Financial Markets in Europe, the United States and Japan*, CPB Discussion Paper No. 238, March 2013.

<sup>40</sup> Cf. Allen, F./Bartiloro, L./Kowalewski, O., *The Financial System of the EU 25*, October 2005, p. 11; similar: Gischer, H./Richter, T., ‘Global Player’ im Bankenwesen – ökonomisch sinnvoll oder problembehaftet?, [2011] FEMM Working Paper Series No. 12, p. 2: decrease of banking concentration by 32% from 1997 to 2008. Branch density developed inconsistently, according to the authors.

<sup>41</sup> Cf. Lahusen, R., *Konsolidierung in europäischen Banksektoren: Große Fortschritte – außer in Deutschland*, DB Research, EU-Monitor, December 2003, p. 4.

<sup>42</sup> See House of Commons, Treasury Committee, *Competition and choice in retail banking*, Report published on 2 April 2011, HC 612-I (so-called Cruickshank Report); further European Commission, press release of 19 September 2001, IP/01/1290.

<sup>43</sup> Cf. *Monopolies Commission*, XV. Main Report, supra, paras. 1, 18 ff. The discussion recently returned with a call for so-called “European Champions”, though this has so far not been related to the banking sector; see Friedrich, T.A., *EU-Industriepolitik soll Champions fördern*, vdi nachrichten, 30 May 2014.

<sup>44</sup> Cf. Allen, F./Bartiloro, L./Kowalewski, O., *The Financial System of the EU 25*, supra, pp. 14 ff.

largest credit institutions remained clearly below 50% until 2007.<sup>45</sup> In the latter two Member States and Ireland, concentration remained low primarily due to the presence of many foreign banks. The genuinely domestic banking sector, in contrast, was much more concentrated. Concentrations where the five largest banks combined more than 80% of the market shares could be observed in Belgium, Estonia, Finland, the Netherlands and, except in one year, in Lithuania already during this period. Branch density developed inconsistently as well. It slightly declined on the whole, however.

**1360.** Starting already in the 1970s and in some respect running counter to the increasing concentration on the national level, there existed a trend towards more European financial market regulation. Cross-border financial activities are a cornerstone of creating a single market, one of the central objectives of the European Union. Particularly, the introduction of the euro currency on 1 January 1999 also made the evolution of a single financial market appear a realistic objective in the longer term and was followed by several cross-border bank mergers, though not by a large number.

**1361.** The banks in the Member States used the opportunities associated with the opening up of the markets for cross-border financial transactions to a varied extent and in different ways. For example, banks in Western and Southern Europe (France, Italy, Spain) expanded into Central Europe, and banks in Central Europe (Belgium, Austria) expanded into Eastern Europe. German and French banks played a major role in the international credit and loan business, followed by Belgian and Italian banks.<sup>46</sup> That said, the significance of cross-border activities in relation to the total balance sheet varied considerably across Member States.

**1362.** The Europeanisation of financial market regulation mainly consisted in a narrowing of the differences in accounting standards and the capital rules at first, and in the introduction of basic legislative standards. In contrast, prudential and market supervision continued to be national until the creation of a banking union, and it was not homogeneous for the entire banking sector, unlike as, for example, in the United States.

**1363.** The differences in regulation and supervision may be seen as a major reason for European financial markets remaining very heterogeneous and highly fragmented overall, despite the increase in cross-border market activities. The conditions imposed on the larger banks in the context of State aid proceedings during the financial crisis (e.g., winding down their foreign business, newly developing a business model focused on their domestic market) increased fragmentation even further. In addition to that, the financial crisis revealed serious market issues due to overcapacities and badly functioning competitive mechanisms.

**1364.** Aside from that, deregulation and rather uncoordinated privatisations took place in some Member States, in Western Europe since the 1980s and in the MOE States after the collapse of the Eastern Bloc.

**1365.** All in all, banking and financial market regulation did not keep pace with the market changes and the development of new financial products (so-called financial innovations) prior to the financial crisis. The financial crisis itself has led to more homogeneous regulation, both across Europe and beyond. The market effects of that regulation cannot be estimated at this point.<sup>47</sup>

**1366.** That said, market observers continue to see the European financial markets as being fraught with problematic market structures. Measured by the market share of the five largest credit institutions, market concentration continued to rise in most Member States in the period from 2008 to 2012, and did so rather strongly in the countries previously exhibiting rather low market concentration

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<sup>45</sup> Cf. ECB, *EU Banking Structures*, October 2006, p. 54; ECB, *EU Banking Structures*, October 2008, p. 38.

<sup>46</sup> Cf. Buch, C.M./Heinrich, R.P., *Financial Integration in Europe and Banking Sector Performance*, Kiel Institute of World Economics, 2002, pp. 7 f.

<sup>47</sup> See below Section 3.6.

by EU-wide comparison.<sup>48</sup> Apart from still-existing overcapacities, also the competition mechanisms continue not to function smoothly. Not enough non-viable banks leave the market, in particular. In addition, the European economic and debt crisis has strongly entwined the financial sector with the national economies in the Member States, which can give rise to major instabilities.<sup>49</sup>

**1367.** Based on current estimates, the banking sector is more concentrated in all EU Member States than, for instance, in the United States, although concentrations within the EU continue to fluctuate considerably.<sup>50</sup> At the same time, the banking systems “balloon” beyond what would be natural. For instance, the assets controlled by banks in the euro area accounted for approximately 270% of Gross National Product (GDP) at the end of 2013, or even more than 330%, adding the subsidiaries of non-EU banks that are seated in the EU. This applies despite the fact that the European banking has shrunk by roughly 10% since the financial crisis (2008). The level of European bank debt continues to stay at alarming rates as well.<sup>51</sup>

### *The evolution of the European capital markets*

**1368.** In the area of company and State financing, the capital markets play an important role aside from bank loans. The capital markets allow market participants to collect capital also from outside their traditional business territory. In several Member States, the capital markets today play an important role as an alternative to the traditional banking sector.

**1369.** Throughout the period since 1995, most national economies outside the EU have developed in an increasingly market-oriented fashion whereas most EU Member States were bank-based from the outset and have even developed further in this direction.<sup>52</sup> Their credit and loan business, in particular, expanded massively until the eruption of the financial crisis in 2007.<sup>53</sup>

**1370.** The regulated stock exchange is a classic case of capital market transactions. In respect of stock market capitalisation, the UK, France, Germany, and Spain dispose of the largest markets at the present time.<sup>54</sup> That said, measured by the ratio of company market capitalisation and GDP, the euro markets continue to be significantly smaller than the US market and also the Japanese market.<sup>55</sup>

**1371.** In the decade preceding the financial crisis, the European regulated markets were often not very attractive for domestic undertakings, which made them sometimes try to be listed at the US exchanges. Apart from accruing costs, this followed also from regulatory deficits in the areas of accounting and investor protection, due to which the US markets were considered more attractive. Listings in other Member States were rarer and were then also frequently related to privatisations (this often, e.g., in the MOE States).<sup>56</sup>

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<sup>48</sup> Cf. ECB, Banking Structures Report, November 2013, pp. 12-13.

<sup>49</sup> See, e.g., Advisory Scientific Committee of the ESRB, Is Europe Overbanked?, ASC Report No. 4, June 2014, p. 22; Schnabel, I., Das europäische Bankensystem: Bestandsaufnahme und Herausforderungen, Wirtschaftsdienst Sonderheft 2014, pp. 6-10.

<sup>50</sup> Cf. Bijlsma, M.J./Zwart, G.T.J., The Changing Landscape of Financial Markets in Europe, the United States and Japan, supra, pp. 31 f.

<sup>51</sup> See Advisory Scientific Committee of the ESRB, Is Europe Overbanked?, supra, p. 4.

<sup>52</sup> Cf. Advisory Scientific Committee of the ESRB, Is Europe Overbanked?, supra, p. 23.

<sup>53</sup> Cf. Bijlsma, M.J./Zwart, G.T.J., The Changing Landscape of Financial Markets in Europe, the United States and Japan, supra, p. 10.

<sup>54</sup> Cf. Quandl, Stock Market Capitalization By Country, <http://www.quandl.com/economics/stock-market-capitalization-by-country>; accessed: 24 June 2014.

<sup>55</sup> ECB, Financial Markets, Equity Market (1990-2012), <https://www.ecb.europa.eu/mopo/eaec/markets/html/index.en.html>; accessed: 24 June 2014.

<sup>56</sup> Allen, F./Bartiloro, L./Kowalewski, O., The Financial System of the EU 25, supra, pp. 22 f.

**1372.** Deregulation, globalisation, and technical innovation, however, have spurred the integration of the European markets and have rendered these markets more attractive. Also the European stock exchanges themselves have contributed to the market development, including Deutsche Börse.<sup>57</sup>

**1373.** The bond markets make up roughly two thirds of the total volume of the European capital markets, i.e., they are more important than the stock markets. Most bonds are issued by the State (approx. 60%), followed by corporate bonds (approx. 30%) and ABS (approx. 10%). A large fraction of the bond trade takes place outside the regulated market (“Over The Counter”). The bond markets are marked by the fact that the securitisation of rights is governed by contracts, taking into account national securities and capital markets law. The United States continues to have the most important bonds market.<sup>58</sup> The importance of the European markets has increased, though, and particularly after 2005.<sup>59</sup> The European market for sovereign bonds, in particular, has been subject to a major overturn in recent years.<sup>60</sup> However, also European companies have identified the bond market for themselves. In view of banking regulation, the general interest level, and the demand for market liquidity, domestic companies have resumed issuing more corporate bonds.<sup>61</sup> It cannot be said at this stage, however, to what extent the bond market in Europe will be an alternative for company financing to the loan market in the long run.

**1374.** Thus, the capital markets are important for sovereign and company funding, but although this is the case, it should be noted that the European economies are consequently not independent from banks. To the contrary, contrary to what one might think, especially the more market-oriented economies have the largest banking sectors, for instance, the UK, France, and the Netherlands. This may be related to the banks’ orientation towards cross-border business and to the fact that also the banks in market-based economies use the opportunities to generate earnings on the capital markets.<sup>62</sup> In addition, it must be considered that banks can frequently not be dispensed with in relation to the issuance of capital market products and related advice (credit-like and other products). Furthermore, banks engage in the capital market for indirectly customer-related transactions (market making, hedging). The role of banks in the derivatives business is particularly noteworthy. While derivatives have expanded worldwide, they have done so in a particularly pronounced fashion in Europe.<sup>63</sup> On a number of EU markets for capital market products, banks therefore are among the most important market participants.

### ***2.3 Relevance of other aspects***

**1375.** In accordance with its statutory mandate, the Monopolies Commission only takes a position on topical issues of competition policy on the financial markets in this Report. To that end, it must however also consider a variety of intertwined regulatory aspects and objectives which are relevant also for competition policy. This variety is due to the central economic role of the financial markets and to certain characteristics of these markets, in particular: multifarious information asymmetries (particularly as regards risks), the connections between market participants, the dependence of

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<sup>57</sup> Cf. *ibid.*, p. 24. However, the merger with NYSE Euronext was blocked in the reporting period; see European Commission, Decision of 1 February 2012, COMP/M.6166 – Deutsche Börse/NYSE Euronext and above Chapter IV, paras. 694 f., 721-743, 763 f.

<sup>58</sup> Cf., e.g., Morgan Stanley, Investmentfocus – The Evolution of the Global Bond Market, April 2012, p. 2.

<sup>59</sup> Cf. Bijlsma, M.J./Zwart, G.T.J., The Changing Landscape of Financial Markets in Europe, the United States and Japan, *supra*, p. 13.

<sup>60</sup> Cf. ECB, Statistical Data Warehouse, 2014.

<sup>61</sup> Cf. Kaya, O./Meyer, T., Unternehmensanleihen in Europa – Wo stehen wir und wohin geht die Reise?, DB Research, EU-Monitor Globale Finanzmärkte, 11 March 2013.

<sup>62</sup> Bijlsma, M.J./Zwart, G.T.J., The Changing Landscape of Financial Markets in Europe, the United States and Japan, *supra*, pp. 28, 36.

<sup>63</sup> Advisory Scientific Committee of the ESRB, Is Europe Overbanked?, *supra*, p. 3.

transactions on certain infrastructures (platforms), sometimes high switching costs, and the complexity and abstractness of products and transactions.

**1376.** Issues of banking and financial market stability play a distinctly prominent role. Given the different maturities of loans and deposits, the financial markets are susceptible to liquidity crises which can threaten the financial intermediaries' solvency (bank runs). In the case of a systemic crisis, the safeguarding of competition must take second place to the protection of the financial system. However, also apart from this issue, aspects of banking and financial market stability overlap with aspects of safeguarding competition. For example, supervisory rules distorting competition are generally objectionable. Moreover, supervisory rules applying uniformly on the relevant markets are usually necessary to prevent any artificial fragmentation of markets.

**1377.** Aspects of competition and consumer protection overlap on the financial markets as well. Sometimes, suppliers are able to disadvantage their customers irrespective of any market power by exploiting the market conditions.<sup>64</sup>

**1378.** Further, other policy aspects can gain competitive relevance in the individual case, for example, where the supply of the population with financial products in the general economic interest is at stake (public-interest services – “*Daseinsvorsorge*”), or to limit ethically or financial transactions that are questionable in terms of social policy (e.g., in relation to commodity speculation).

**1379.** Throughout its Report on competition on the financial markets, the Monopolies Commission takes these various aspects into account whenever relevant.

### 3 Systemic relevance and systemic stability

#### 3.1 Introduction

**1380.** The Monopolies Commission's competition policy mandate includes the task of evaluating, to the extent necessary, whether and to what extent competition is distorted by regulation, and whether these distortions can be removed by the current amendments to financial market regulation. In addition, it may evaluate the other competitive effects of that regulation on the financial and the real economy. In contrast, a general politico-economic evaluation of the financial market regulation is not part of the Monopolies Commission's mandate and therefore does not feature in this Report.

The principle of undistorted competition is a fundamental principle of EU law, which is binding for the Legislature and the executive given the Legislature's approval of the EU Treaties.<sup>65</sup> Against this backdrop, the Monopolies Commission is entrusted with the task of giving recommendations as to how the principle of undistorted competition can be adequately aligned with the objective of financial stability by means of consistent regulation of the financial markets.<sup>66</sup>

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<sup>64</sup> In that regard, the FCO stated long ago that “the consumer is clearly not in a position, contrary to large industrial customers, to use its margin of manoeuvre opened through competition” (unofficial translation of “*der Verbraucher im Gegensatz zum industriellen Großkunden offensichtlich nicht in der Lage ist, seinen durch den Wettbewerb geschaffenen Spielraum zu nutzen*”); cf. FCO, Activity Report 1976, BT-Drs. 8/704, p. 91.

<sup>65</sup> Protocol No. 27 to the Treaties, OJ C 115, 9 May 2008, p. 309; see also ECJ, Judgment of 21 February 1973, 6/72, *Continental Can*, [1973] E.C.R. 215, para. 23.

<sup>66</sup> Cf. European Commission, Communication – The recapitalisation of financial institutions in the current financial crisis [...] (Recapitalisation Communication), OJ C 10, 15 January 2009, p. 2, paras. 16, 20; Communication on the treatment of impaired assets [...] (Impaired Assets Communication), OJ C 72, 26 March 2009, p. 1, para. 13; Communication on the return to viability and the assessment of restructuring measures [...] (Restructuring Communication measures), para. 29.

### ***3.2 The stabilisation of the financial markets must be aligned also with the objectives of competition policy***

**1381.** The Monopolies Commission acknowledges the achievements of the German authorities in stabilising the financial markets during the crisis, though it also considers it to be important that competitive aspects will have a greater bearing on the evolution of financial market policy in the future. Current financial market regulation does not seek to regulate the financial sector by means of competition policy, but it is oriented towards stability and fiscal policy objectives instead. Consequently, an important field remains unused and open to the Government's and the Legislature's competition policy. The Monopolies Commission's recommendations have the following basis in that respect.

**1382.** Current financial market regulation would be neutral from a competition policy perspective if financial market stability were an issue that could be assessed in isolation. Indeed, questions of competition and financial market stability are regulated separately from one another. Competition regulation concerns the market position of the relevant bank (institution)<sup>67</sup> and its behaviour when supplying or sourcing financial products and services in competition. Financial market regulation includes rules concerning the risk associated with financial market products for other market participants. It is supposed to ensure the stability of individual banks with regard to those risks, and also to serve systemic stability. Both areas of regulation can be considered separately to a certain extent. For example, Deutsche Bank is considered to be systemically relevant although it has not enjoyed market power on the relevant markets that have been assessed by the competition authorities to date. In contrast, the savings banks and the cooperative banks are typically not systemically relevant although they may have a locally or regionally dominant market position in retail banking.

**1383.** That being said, there are overlaps between the two regulatory areas. These overlaps result directly from the core task of banks to provide for capital allocation in the national economy. The banks achieve their profits by supplying credit, for example, where they can earn the highest interest, taking into consideration the risk. Thus, the different investment opportunities are in competition with one another when the banks vie with each other for investor capital. At the same time, in the borrowers' view, the products of individual banks compete with each other and with the products of alternative credit suppliers. Hence, the existing business relations are essentially determined through competition.<sup>68</sup> That competition, however, takes place with products and for products that are connected with risk. The products and the connected risk cannot be assessed wholly independently from one another.

**1384.** This does not exclude that either financial market regulation or the competition rules claim priority, depending on the circumstances. For instance, the financial crisis demonstrated clearly that the market power of individual market participants no longer plays a role if systemic risk materialises and the market structures are entirely on the brink of collapse. In this case, the priority is clearly with measures to stabilise the system short-term, and thus with financial market regulation. That said, it is also true that financial market regulation and the competition rules must be aligned with each other in the longer term as they create a regulative framework in their interplay, within which competition arises on the financial markets.

**1385.** A consequence is that there is currently room for manoeuvre in terms of competition policy on the financial markets. It is true that most of the measures adopted to regulate the financial markets since the outbreak of the crisis have been necessary to rein in the acute systemic danger associated

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<sup>67</sup> In this Chapter, the term "institution" is used according to the definition in Article 4(1) No. 3 of Regulation 575/2013 (credit institution or investment firm), and also synonymously to the term "bank" in the Sections not concerning the issues of capital and shadow banking.

<sup>68</sup> See Section 4.5.2 on development banks where this only applies with certain limitations.

with the crisis and to re-establish systemic stability short-term. However, the more these short-term problems are being solved, the more questions of long-term political design come to the fore again. The political mandate for such design calls increasingly for harmonising the objective of stabilising the financial system with the objectives of protecting competition and other policy objectives set out by EU law (e.g., the internal market) and the Basic Law (*Grundgesetz*; e.g., the social welfare principle, the social restrictions to market-economy property). One-sidedly pursuing the objective of stabilising the system does not meet these requirements in the long term.

**1386.** In the Monopolies Commission's view, the primacy of competition must be the starting point for a readjustment of competition policy since competition dispels market power and, as a rule, is thereby inherently directed towards stabilising the system. This applies at least as long as deficient regulation does not channel competition in a way that leads to risk accumulations that put the financial system at risk. In the financial crisis, the risk on the financial markets threatened systemic stability, among others, because individual banks (Lehman Brothers, HRE, *Landesbanken*, etc.) were able to visibly gain systemic relevance, which meant that they could no longer leave the market without this threatening the entire financial system. For these systemically relevant institutions, thus, a core principle of competition disapplied, i.e., the principle that generally all market participants must be able to leave the market in competition.<sup>69</sup> This must be taken into account in the future design of regulation. In that context, it is necessary to consider that it is usually easier to break down market power through competition than to curb that power permanently through regulation.

**1387.** Against this backdrop, the Monopolies Commission is concerned that there is no debate so far regarding the adequate harmonisation of stability and competition aspects in relation to financial market regulation, even though measures are adopted that will have a deep impact on the financial sector. It must be regretted that legislative proposals even on controversial regulation are presented without addressing alternatives, even where alternatives are discussed in the political arena, or where they at least suggest themselves.<sup>70</sup> In Germany, a discussion of opposing viewpoints occurs even less than in the EU where the European Commission makes regulatory proposals without direct democratic involvement, but where it offers the possibility for opinions to be expressed freely in its consultations, assesses the alternatives brought forward in a comprehensive and published Impact Assessment, and works out the characteristic benefits of the chosen alternative on that basis.

**1388.** A policy one-sidedly oriented towards financial market stabilisation and fiscal aspects (the cost of the financial crisis) is associated with risks that are difficult to appraise. The financial markets react very sensitively to changes of the competitive conditions. Incompletely devised regulation merely induces competition to shift into areas not covered by the regulation. In that context, the rule is that comprehensive regulation only contains more gaps that market participants will exploit in competition. Apart from that, regulation will in any case have repercussions on the allocation of market power in the financial sector. Thus, regulation itself can result in competition distortions that can entail risks for the stability of the markets. In addition, it can have repercussions outside the financial sector, on the real economy.

**1389.** The Monopolies Commission submits recommendations in this Report, observing its mandate, on how the further development of financial market regulation can be used to reduce competition distortions ensuing from the systemic relevance of individual market participants and the related

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<sup>69</sup> See Sections 3.4 ff. for the details.

<sup>70</sup> Cf. Federal Government, Legislative Proposal, Entwurf eines Gesetzes zur Abschirmung von Risiken und zur Planung der Sanierung und Abwicklung von Kreditinstituten und Finanzgruppen, BT-Drs. 17/12601; similarly Entwurf eines Gesetzes zur Umsetzung der Richtlinie 2012/.../EU über den Zugang zur Tätigkeit von Kreditinstituten und die Beaufsichtigung von Kreditinstituten und Wertpapierfirmen und zur Anpassung des Aufsichtsrechts an die Verordnung (EU) No. .../2012 über die Aufsichtsanforderungen an Kreditinstitute und Wertpapierfirmen (CRD IV-Umsetzungsgesetz), BR-Drs. 510/12. It is expressly noted in the Proposals: "Alternatives to all Articles: None." and "Alternatives: None."

regulation, and how the market forces operating in the financial sector can be brought to bear in a positive way. It considers it to be urgent that politicians, beyond short-term anti-crisis measures, attend more decidedly and in the most pro-competitive way possible to the long-term design mandate that it has on the financial markets.

**1390.** In this context, the Monopolies Commission limits its Report to the regulation of economic activities on the financial markets. It does not address the measures of the European central banks, underlining however that these measures also have substantial – though quite unpredictable – competitive effects at the present time.<sup>71</sup>

### 3.3 Systemic relevance as a stability problem

**1391.** The systemic relevance of banks is at the centre of the current international efforts in developing the financial market architecture further. The United States was one of the first countries to take steps towards comprehensive special regulation of large systemic banks.<sup>72</sup> Reaching further, German politicians endeavour to ensure that no institution is or becomes so big in the future that it can “hold the State for ransom” regarding the consequences of its failure. Increasingly, awareness is developing that these issues have to be resolved not only with regard to banks, but with regard to all financial market participants – including the ones pertaining to the so-called shadow banking sector.

#### 3.3.1 Characteristics of systemic relevance

**1392.** Financial market participants are viewed to be systemically relevant if they play such an important role in the financial system that their failure cannot be accepted. At present, there is not conclusive and generally applied definition of systemic relevance. That said, there is consensus that the determination of systemic relevance does not hinge on the size, complexity, and market power of a financial market participant as such, but rather on the interconnectedness with competitors and the other side of the market and on the associated danger that the risks between financial market participants can spread without control (contagion effects).<sup>73</sup>

**1393.** Thus, the Financial Stability Board (FSB) defines systemically important institutions (SIFIs) as financial institutions “whose distress or disorderly failure, because of their size, complexity and systemic interconnectedness, would cause significant disruption to the wider financial system and economic activity”.<sup>74</sup> This is broadly in line with the definition of systemic importance in the US American Dodd-Frank Act, where the risk of out-of-control risk contagion is addressed explicitly.<sup>75</sup> In

<sup>71</sup> See the reference of the German Constitutional Court (*Bundesverfassungsgericht*) to the European Court of Justice in the matter BVerfG, 2 BvR 2728/13, et al. (previously: 2 BvR 1390/12, et al.), on the significance of Article 127(1)(3) TFEU for the actions of the ECB from a constitutional perspective (see also BVerfG, press release No. 9/2014 of 7 February 2014); on the competition law assessment of central bank activities, see moreover European Commission, Communication – The application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis (Banking Communication), OJ C 270, 25 October 2008, p. 8, para. 51 (with restrictions).

<sup>72</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”), Pub.L. 111–203, H.R. 4173 (proposed 2009, in force since 2010).

<sup>73</sup> See preamble to Federal Government, Legislative Proposal, Entwurf eines Gesetzes zur Restrukturierung und geordneten Abwicklung von Kreditinstituten, zur Errichtung eines Restrukturierungsfonds für Kreditinstitute und zur Verlängerung der Verjährungsfrist der aktienrechtlichen Organhaftung (Restrukturierungsgesetz), BT-Drs. 17/3024 of 27 September 2010, 103.

<sup>74</sup> Cf. FSB, Policy Measures to Address Systemically Important Financial Institutions, 4 November 2011: “To avoid this outcome, authorities have all too frequently had no choice but to forestall the failure of such institutions through public solvency support. As underscored by this crisis, this has deleterious consequences for private incentives and for public finances.”

<sup>75</sup> Sec. 803(9) des Dodd-Frank Act: “The terms ‘systemically important’ and ‘systemic importance’ mean a situation where the failure of or a disruption to the functioning of a financial market utility or the conduct of a payment, clearing, or settlement activity could create, or increase, the risk of significant liquidity or credit

EU law, the problem of systemic relevance is addressed in various contexts, in particular in the rules on the resolution of banks and in the legal basis for the European Systemic Risk Board (ESRB).<sup>76</sup> There as well, emphasis is put on the crucial element of risk that may threaten the stability of the entire financial system, and on the fact that systemic relevance does not depend on size alone, but also on the functions of an institution within the financial system, its indispensability and the level of interconnectedness.<sup>77</sup>

**1394.** In German law, §§ 48a, 48b KWG do not contain a definition of systemic relevance, but they still make clear that the existing regulation concerning systemic relevance is based on the interdependence of threats to the institution and threats to the financial system.<sup>78</sup> Under § 48b(2) KWG, the financial system is threatened

*“if there is reason to be concerned that the threat to the survival of the credit institution will have a significant negative impact on other undertakings in the financial sector, on the financial markets, or the general confidence of the depositors and other market participants in the functioning of the financial system.”\**

Based on this concept, Article 6(1) of the prudential authorities’ Supervisory Guidance<sup>79</sup> includes the following definition:

*“Systemically relevant institutions are institutions where, if their survival were threatened, this would provoke significant negative effects at other credit institutions given their size, the intensity of their interbank relations, and their close interconnections with foreign countries, and could destabilise the financial system.”\*\**

In view of the different systemic effects, the authorities distinguish between banks of global and of national systemic relevance.<sup>80</sup>

### ***3.3.2 Variations of systemic relevance (too big/too connected/too many to fail)***

**1395.** In the view of financial market experts, it is possible to distinguish different variations of systemic relevance. According to the above definitions, it is a common feature of these variations that

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problems spreading among financial institutions or markets and thereby threaten the stability of the financial system of the United States.” (also, see Sec. 203, 809).

<sup>76</sup> See Articles 2 lit. c, 3(1) of Regulation 1092/2010; further Article 4(1) No. 11 of Regulation 575/2013, and previously Article 124(4) of Directive 2006/48/EC and as to branches Article 1(4) of Directive 111/2009 (as well as the Proposal COM(2008) 602 of 1 October 2008); moreover, see EESC, Opinion on the Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the European Central Bank - Regulating financial services for sustainable growth COM(2010) 301 final, OJ C 107, 6 April 2011, p. 21, Section 3.11.2.; <http://www.esrb.europa.eu/about/tasks/html/index.de.html>; accessed: 24 June 2014.

<sup>77</sup> Individual products or data can be systemically relevant as well or make the entity controlling them systemically relevant, cf. Section 5.6 and Article 17(5) and Recitals 52-53 of Regulation 596/2014 on market abuse (Market Abuse Regulation), OJ L 173, 12 June 2014, p. 1.

<sup>78</sup> However, see also § 1(4) No. 2a Rettungsübernahmegesetz (RettungsG) for a definition of systemic relevance in German law, today obsolete due to § 6(1) RettungsG.

\* “[W]enn zu besorgen ist, dass sich die Bestandsgefährdung des Kreditinstituts in erheblicher Weise negativ auf andere Unternehmen des Finanzsektors, auf die Finanzmärkte oder auf das allgemeine Vertrauen der Einleger und anderen Marktteilnehmer in die Funktionsfähigkeit des Finanzsystems auswirkt.” (unofficial translation).

<sup>79</sup> BaFin, Supervisory Guideline of 21 May 2013.

\*\* “Systemrelevante Institute sind Institute, deren Bestandsgefährdung aufgrund ihrer Größe, der Intensität ihrer Interbankbeziehungen und ihrer engen Verflechtung mit dem Ausland erhebliche negative Folgeeffekte bei anderen Kreditinstituten auslösen und zu einer Instabilität des Finanzsystems führen könnte.” (unofficial translation)

<sup>80</sup> Cf. also Basel Committee on Banking Supervision, Global systemically important banks: assessment methodology and the additional loss absorbency requirement, Rules text, November 2011.

the materialisation of risks threatens the survival of financial market participants, and destabilises the financial system by way of contagion. However, they differ in which financial market participants face a threat to their survival:<sup>81</sup>

- Too big to fail: A situation where particularly large, complex, or numerous risks are concentrated at a financial market participant that has business or other relations (i.e., interacts) with other financial market participants, and where those risks materialise in a way that threatens the survival of the relevant market participant.<sup>82</sup>
- Too connected to fail: A situation where multiple financial market participants are in a way interconnected due to their interaction that particularly large, complex, or numerous risks are concentrated on all of these financial market participants, and where those risks materialise in a way that threatens the survival of one or more market participants.
- Too many to fail: A situation where several financial market participants pursue a business with similar risks, without these financial market participants being interconnected, and where those risks materialise in a way that threatens the survival of those market participants.

In the reality of the financial business, the aforementioned categories probably overlap frequently. In particular, it must be assumed that banks identified as systemically relevant by the FSB or the German prudential authorities can frequently be considered not only as being “too big to fail”, but also as being “too connected to fail”.<sup>83</sup>

**1396.** The Monopolies Commission considers it necessary to assess the competition-policy relevance of systemic connections in more detail. Such research would shift the focus from the financial market participants whose distress or survival is systemically relevant to the business relations between the financial market participants and the risks associated with these business relations. A first possible step in this direction is taken by a Swiss survey that assessed the business connections between the financial market participants in the period 2008 to 2010, and that identified a group of 22 banks globally that appear to have occupied a systemic key position during the financial crisis.<sup>84</sup> A broader circle of the 50 most systemic relevant undertakings also included other financial investors apart from banks. The latter group included companies many of which probably only have limited activities in Germany. The list of relevant undertakings diverges from the FSB’s list of globally systemically relevant banks. It is also still unclear to what extent those undertakings are able to exert a competitively significant influence due to their systemic relevance in Germany.

**1397.** It is problematic that the lack of commonly accepted criteria for the determination of systemic relevance<sup>85</sup> may induce partly questionable simplifications. In the public perception, the most

<sup>81</sup> See Hellwig in: Hellwig/Höfling/Zimmer, Gutachten E/F/G zum 68. Deutschen Juristentag, Munich 2010, pp. E 29-30; further, see Höfling, *ibid.*, p. F 59 on BaFin’s risk classification in 2008.

<sup>82</sup> The term “too big to fail” is common, though it is misleading as the relevant market participant does not have to be large (“too big”) and as not the failure is decisive (“to fail”), but its systemic consequences. The addressed connections are relevant in the broadest sense (information channels between the financial market participants, e.g., can be sufficient).

<sup>83</sup> Such overlaps should also exist, e.g., where institutions are regarded as “too complex to fail”; see IMF/BIS/FSB, Guidance to Assess the Systemic importance of Financial Institutions, Report to the G-20 Finance Ministers and Central Bank Governors, October 2009, p. 13. It is unclear to date whether this term denotes an individual category of systemic relevance.

<sup>84</sup> Cf. Battiston, S., et al., DebtRank: Too Central to Fail? Financial Networks, the FED and Systemic Risk, *Nature Scientific Reports* Vol. 2, Article 541, 2 August 2012; further Hesse, D./Strehle, R., “Too connected to fail”, *Basler Zeitung*, 29 October 2011. The study identifies Deutsche Bank AG and Allianz SE as part of the network of the 50 most influential firms.

<sup>85</sup> Cf. IMF/BIS/FSB, Guidance to Assess the Systemic importance of Financial Institutions, *supra*. The definition of SIF used in this Guidance is itself criticised as being too narrow. See Nastansky, A., *Systemrelevante Finanzinstitute*, WISU 42(8/9), 2013, pp. 1057-1060, for an overview of the different

important category of financial market participant is the category of undertakings that can be labelled as “too big to fail”, a category where absolute size is commonly taken as an indication for the presence of systemic relevance. Indeed, research suggests that banks with a balance sheet total of USD 100 billion must be regarded as being “too big to fail”.<sup>86</sup> However, the issue of systemic relevance extends beyond the category of “too big to fail”.

**1398.** The lack of clear relevant criteria led in the financial crisis to the rescue of relatively small institutions because they were alleged to be “systemically relevant”.<sup>87</sup> It is not possible to assess from the outside whether these rescue measures were justified or not. In any event, the risk exists that such cases will be taken as precedents in the future to justify the saving of not genuinely systemically relevant banks, simply because the public trusts that the banks will be rescued and expects the rescue. In essence, thus, potentially any institution would have to be saved as being “too big to fail”. This would not only defeat the purpose of the efforts for creating a European single resolution mechanism, but it would also have incalculable effects on the competitive situation in the financial markets. Therefore, the Monopolies Commission advocates that at least the legal criteria for the determination of systemic relevance be harmonised to the extent possible in the longer term, and that they be framed and published in a way that allows the public to understand why a financial market participant is rescued or not.

**1399.** Consequently, the above-mentioned categories of the variations of systemic relevance have only a limited meaning. However, the categories are broadly accepted, and they are significant at least in so far as the measures of financial market regulation are necessarily incomplete if they only address one category of systemic relevance, but not the others.

### ***3.4 Implicit State guarantees as a problem for competition***

**1400.** The Monopolies Commission considers systemic relevance to be problematic if other market participants can become aware and react to it. Banks and other financial market participants are said to benefit from an implicit State guarantee because it cannot be suffered that they leave the market.<sup>88</sup> This State guarantee is implicit because it is not based on an express State measure. It is not directly captured by State aid law.<sup>89</sup>

#### ***3.4.1 Characteristics and effects of implicit guarantees***

**1401.** The expectation for an implicit guarantee provides incentives to the financial market participants to grow beyond an efficient size or to accept more risk in other ways, in order to obtain

approaches to measure systemic relevance.

<sup>86</sup> See, e.g., Brewer III, E./Jagtiani, J., How Much Would Banks Be Willing to Pay to Become ‘Too-Big-to-Fail’ and to Capture Other Benefits, The Federal Reserve Bank of Kansas City RWP 07-05, July 2007, p. 13; Penas, M.F./Unal, H., Gains in Bank Mergers: Evidence from the Bond Markets, *Journal of Financial Economics* 74(1), 2004, p. 149-179; Kane, E.J., Incentives for Banking Megamergers: What Motives Might Regulators Infer from Event-Study Evidence?, January 2000.

<sup>87</sup> For instance, the eighth- and ninth-largest Danish banks Roskilde and Fiona with balance sheet totals of EUR 5 billion and EUR 4.4 billion respectively, see European Commission, Decision of 5 November 2008, NN 39/2008, Denmark (Roskilde), para. 77; Decision of 20 May 2009, NN 23/2009, Denmark (Fiona Bank), paras. 2, 44-46.

<sup>88</sup> The attribution of an implicit guarantee probably also retro-acts on the systemic relevance: When the market participants (re-)evaluate the risk of a bank, taking into account an implicit guarantee, already the valuation will be suffice to make the bank systemically relevant, irrespective of the question whether this valuation is justified on objective grounds (higher estimated risk).

<sup>89</sup> Articles 123(1), 125(1)(2) TFEU, if anything, address the issue indirectly in so far as the use of implicit guarantees puts an excessive burden on the individual Member State.

the benefit of the implicit guarantee or are even able to extend that guarantee under the circumstances (“moral hazard”). This may go along with significant distortions of competition.<sup>90</sup>

- For the relevant undertaking, the implicit guarantee has the effect of a guarantee of survival. Thus, the competition principle is rendered ineffective that generally every market participant must be allowed to leave the market.
- In the context of business relations, the implicit guarantee is moreover linked to indirect benefits because other market participants take the guarantee into account constantly. This gives rise to funding advantages in particular, because the investors do not have to consider the systemically relevant undertakings’ risk of insolvency in their pricing.

**1402.** The competitive advantage associated with an implicit guarantee is the larger it is, the more the market assumes that the systemically relevant undertaking is in a position to transfer risks to the State by means of the guarantee. In that context, the undertaking probably benefits from the fact that the financial markets are still marked by a substantial lack of security, meaning that other financial market participants will in doubt assume relatively early State measures. In that regard, one may question whether any declaration that the State would not grant to certain banks its protection would be credible at all.<sup>91</sup>

**1403.** For these reasons, undertakings can be assumed to have an incentive to exploit regulatory gaps in areas with high risk since the prospect of an arising implicit State guarantee is particularly high in such instances. Such engagements could be seen in the banking sector before the financial crisis started in 2007, which is discussed in the following sections.<sup>92</sup> It cannot be ruled out at the present time that similar risks are evolving again in some areas.<sup>93</sup>

### **3.4.2 *Rescue expectations as the cause***

**1404.** If market participants become aware that a bank or other financial market actor may not leave the market due to its systemic relevance, they associate this finding with the expectation that the State will rescue this financial market actor during a crisis. These rescue expectations can have a twofold effect on the bank itself. On the one hand, they can make the bank take on more risk because it assumes that it will be rescued in a situation of distress (“moral hazard”). On the other hand, they can distort competition by improving the refinancing cost situation of a bank considered to be systemically relevant, which provides the bank with a competitive advantage vis-à-vis non-systemically relevant institutions. Whereas empirical literature has already analysed the moral hazard effect to a relatively large extent, and has found indications for an increased risk appetite<sup>94</sup>, the influence of the rescue

<sup>90</sup> This is also the view of the European competition authorities, see, e.g., European Commission, Communication – The application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis, OJ C 270 of 25 October 2008, p. 8, para. 27. It should be possible to rule out competitive effects if the guarantee only exists in the view of the competent prudential authorities without the systemically financial market actor itself or other market participants being aware of that guarantee. This should, however, be a theoretical case.

<sup>91</sup> Negating: Hellwig in: Hellwig/Höfling/Zimmer, Gutachten E/F/G zum 68. Deutschen Juristentag, supra, p. E 55.

<sup>92</sup> See, in the following, Section 3.5.1.

<sup>93</sup> See Bakk-Simon, K., et al., Shadow Banking in the Euro Area. An Overview, ECB Occasional Paper Series No. 133, April 2012, p. 21; EUSIPA, press release of 2 September 2013, and the development of the ABX-Index (Markit) in 2012-2013; further, from the press: Paul, H., Die Kreditmaschine läuft wieder heiß, FAZ, 28 February 2013 (as to the US), and already previously Katzensteiner, T./Papendick, U.-T., Kasino Fatal, manager magazine, 1 April 2011, 31, according to whom banks have re-started to invest in structured and shadow banking product (particularly, in the US). Concerning the available data in general, see FSB, Global Shadow Banking Monitoring Report 2012, 28 November 2012.

<sup>94</sup> Cf. Black, L./Hazelwood, L., The Effect of TARP on Bank Risk-Taking, International Finance Discussion Paper 1043, March 2012; Dam, L./Koetter, M., Bank Bailouts and Moral Hazard: Evidence from Germany,

expectations on bank competition has barely been analysed to date. If anything, then studies exist on the influence of rescue measures on competition in the banking sector. For instance, it has been determined for the United States that the banks taking part in the TARP programme were able to enlarge their market share and market power, in particular if they paid back the granted aid swiftly.<sup>95</sup>

**1405.** Regarding the expectations of whether it is probable that a credit institution in distress will be rescued, the Monopolies Commission and the Economics Expert Council commissioned a survey to analyse the effects of such expectations on the risk appetite of the responsible individuals, and the development of competition in the German banking sector.<sup>96</sup> Based on a sample covering a large fraction of all universal banks and mortgage banks in Germany in the 1995 to 2010 period, econometric methods were used to gauge the market effects of the rescue expectations resulting from the existence of the bank-specific security systems and the rescue measures adopted by the Federal Agency for Financial Market Stabilisation (FMSA). The survey showed that a higher rescue expectancy increases the risk appetite of the responsible individuals and the market power of banks already in distress significantly.<sup>97</sup> In addition, the survey provided indications for the comprehensive FMSA rescue measures having an additional reinforcing effect on the risk appetite and the market power of the relevant banks, as compared to the bank-specific security mechanisms. There was no clear result as to the question whether the increased market power of these banks followed from lower cost or higher earnings.

**1406.** As an interesting element, a division of the sample into two sub-samples for the 1995–2007 and 2008–2010 periods shows that rescue expectations had a significantly positive effect on the risk appetite only for the period before 2008. An increase in market power, in turn, can only be established for the period after 2007. In addition, further estimates distinguishing between individual banking groups and stakeholder groups and regional business activities respectively show that increased rescue expectations always seem to entail a higher risk appetite.<sup>98</sup> According to the survey, however, the market power due to increased rescue expectations, as measured by the Lerner Index, only increased for private credit institutions and cooperative banks. To the extent that the overall sample establishes a positive effect of the rescue expectations on market power, this appears to be relevant particularly as to the cooperative banks, which are active throughout the country. This may be due to the fact that rescue measures distort competition in particular where undertakings have only relatively few financing alternatives to traditional bank credit.

**1407.** Other studies have tried to quantify the financial value of the rescue expectations. For example, a US study established that the large banks considered for the study on the average benefited from a refinancing advantage of 24 basis points or USD 30 billion per year between 1990 and 2011, due to implicit guarantees. In 2009, the value of these guarantees amounted to even more than 100 basis points, or USD 170 billion.<sup>99</sup> For large British banks, economists of the Bank of England calculated

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Review of Financial Studies 25(8), 2012, pp. 2343-2380.

<sup>95</sup> Cf. Berger, A.N./Roman, R.A., *Did TARP Banks Get Competitive Advantages?*, November 2013.

<sup>96</sup> On the following, see Koetter, M., *Market Structure and Competition in German Banking*, supra (fn. 10).

<sup>97</sup> It was discovered that an increase of rescue expectations by one unit of the standard deviation raises the disposition towards risk by 8.2% and the Lerner Index, an indicator of market power, by 1.7%. Taking into account an average probability of 6.3% that a bank defaulted in the period 1995–2010, and an average Lerner Index of 38.4%, the expectations about the probability that a bank in distress will be rescued are economically significant. Cf. Koetter, M., *Market Structure and Competition in German Banking*, supra (fn. 10), p. 88.

<sup>98</sup> Banking groups are differentiated based on whether they are Members of the Sparkassen- und Giroverband, commercial banks, cooperative banks, or mortgage banks; regarding the groups of owners, a distinction is made between private and public law credit institutions; and regarding the regional footprint, a distinction is made between credit institutions primarily active on the regional level and supra-regionally active institutions.

<sup>99</sup> Cf. Acharya, V.V./Anginer, D./Warburton, A.J., *The End of Market Discipline? Investor Expectations of Implicit State Guarantees*, December 2013.

the value of the implicit guarantees during the financial crisis at up to GBP 125 billion per year – depending on the calculation method and the year of the crisis.<sup>100</sup> Studies of the OECD made conservative estimates using credit ratings, and show for a sample of 100 large European banks that implicit guarantees increased in value from EUR 20 billion to up to EUR 120 billion per year between 2008 and July 2011. Since then, the figures have tended to decrease, which is essentially traced back to the multitude of regulatory measures adopted. Then again, however, a significant refinancing advantage of EUR 50 billion still was established for the relevant banks in 2013. For the ten German banks in the sample, the value was approximately EUR 10 billion per year.<sup>101</sup> Despite all the uncertainties associated with them, such estimates show the significant value of rescue expectations – in particular in times of crisis.

**1408.** The volume of the rescue expectations can also be inferred from the ratings that investors take as a basis when investing in products allowing the systemically relevant undertakings to refinance themselves. For example, the State support for banks in Germany improved the rating by the agency Fitch for 19 out of 23 assessed banks in Germany still in March 2014, notwithstanding the fact that the rating agency applies a narrow understanding of implicit guarantees.<sup>102</sup> This was to the particular benefit of the large German banks and the *Landesbanken* because small institutions (including most savings and cooperative banks) do not pursue business activities requiring them to obtain a credit institution rating. Six of the *Landesbanken* alone continue to enjoy a rating improved by one to two notches according to Fitch, as compared with a situation without an implicit State guarantee.<sup>103</sup> The situation at the large German banks is similar. Such an improved rating removes the incentives for investors to ask the respective bank for investment remuneration that would be risk-adequate under non-distorted market conditions. At the level of the investors, thus, there continues to be confidence that the State will adopt measures to aid the systemically relevant institution in case of distress. Consequently, the relevant institutions need not reflect the risk of the investments adequately in the sales prices of the investments they offer (e.g. issued securities). Likewise, the CDS markets reflect distorted risk assessments to the degree that any home State would be in a position to save the relevant institutions.<sup>104</sup>

**1409.** The publications addressing the investors of systemically relevant banks can sometimes be taken as evidence that these institutions indeed base their business strategy on rescue expectations. The annual report of Commerzbank is an interesting example in that respect. This bank ran into serious economic difficulties in the second half of 2008, which caused the Sonderfonds Finanzmarktstabilisierung (SoFFin) to take on a silent participation of EUR 8.2 billion in it, and to provide a guarantee framework to its benefit in the amount of EUR 15 billion. In May 2009 this support was supplemented by a capital increase amounting to EUR 1.8 billion and another silent participation in the amount of EUR 8.2 billion.<sup>105</sup> Nevertheless, Commerzbank did not address the fundamental problems of the bank in its business report for the year 2008, but rather it declared:

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<sup>100</sup> Cf. Noss, J./Sowerbutts, R., The Implicit Subsidy of Banks, Bank of England Financial Stability Paper No. 15, May 2012.

<sup>101</sup> Cf. Schich, S./Bijlsma, M./Mocking, R., Improving the Monitoring of the Value of Implicit Guarantees for Bank Debt, OECD Journal: Financial Market Trends 2014(1), March 2014.

<sup>102</sup> Cf. FitchRatings, Various Support Ratings Paths for German Banks, Special Report, 14 April 2014. Fitch only considers implicit guarantees where a sufficiently concrete ability and disposition exists to support those institutions; cf. FitchRatings, Global Financial Institutions Rating Criteria, Master Criteria of 31 January 2014.

<sup>103</sup> Cf. FitchRatings, Various Support Ratings Paths for German Banks, Special Report, 14 April 2014, p. 7.

<sup>104</sup> Cf. Völz, M./Wedow, M., Does Banks' Size Distort Market Prices? Evidence for Too-Big-to-Fail in the CDS Market, Deutsche Bundesbank Discussion Paper Series 2: Banking and Financial Studies No. 06/2009; see also Demirgüç-Kunt, A./Huizinga, H., Are Banks Too Big to Fail or Too Big to Save? International Evidence from Equity Prices and CDS Spreads, World Bank, WPS5360, July 2010.

<sup>105</sup> European Commission, Decision of 7 May 2009, N 244/2009, Commerzbank – Germany, paras. 29 ff. As a matter of fact, the guarantee was only used in an amount of EUR 5 billion; see Historischer Überblick über

*“We were able to respond to th[e] challenging [market] environment thanks to solid liquidity management and a healthy funding structure. A substantial increase in customer deposits and a silent participation by the Special Fund for Financial Market Stabilization (SoFFin) also provided a welcome buffer. Our customer-oriented business played a role in keeping our liquidity within a comfortable range over the entire year.”*<sup>106</sup>

Apart from that, Commerzbank put much emphasis in its self-presentation on the business strategy aimed at aggressive growth:

*“In 2008, the financial markets and banking sector faced great challenges worldwide – a situation which will continue in 2009. Despite this difficult environment, we took important steps in the past business year towards establishing Commerzbank as the leading bank in Germany for private customers and SMEs.”*<sup>107</sup>

In this context, the aid provided was apparently considered to be an integral part of the bank’s business strategy. Similar evidence can be found in the publications of other institutions which the State had to rescue during the crisis<sup>108</sup>, or which are in any case controlled by the State.<sup>109</sup>

**1410.** More recent statements coming from Deutsche Bank are, however, of a different tone. A member of the institution’s Board has laid a stress on the stability-enhancing effects of banks that are so large that they can also support extreme strain without falling into distress (“too strong to fail”). In that regard, Deutsche Bank could allegedly be part of a solution to the present problems.<sup>110</sup> This does not change anything, though, in that the market is likely to expect the rescue of Deutsche Bank if it is in distress. Deutsche Bank may consider itself independent from such expectations (almost as a “system within the system”). Still, it is not completely detached from the market forces.

### ***3.4.3 Inadequate regulation as the deeper cause***

**1411.** The rescue expectations forming the basis of an implicit State guarantee can have different origins. That said, a fundamental reason is provided by regulation that is not sufficiently directed towards the business risks and that makes it possible for the financial market participants to build up systemic risk and to shift it to the State – i.e., eventually, the public. This does not necessarily mean that there is an insufficient degree of regulation (underregulation). To the contrary, it may have to be assumed under the circumstances that implicit guarantees can also be reinforced if the business of the relevant undertaking moves into non-regulated areas due to exceedingly narrow and rigid burdensome regulation (over-regulation).

die Maßnahmen des SoFFin, current as of 31 December 2013.

<sup>106</sup> Quote of CEO Blessing, Commerzbank, Annual Report 2008, p. VIII.

<sup>107</sup> Quote of CEO Blessing, Commerzbank, Annual Report 2008, p. VI.

<sup>108</sup> HRE, Annual Report 2008, pp. 7 f.: “Further adequate liquidity support provided by the Federal Republic of Germany is an essential precondition for the continued existence of the Hypo Real Estate Group as a going concern. [...] The need for a specialist bank which will come into being as a result of the restructuring is obvious.” [Note the German version: “Der Bedarf nach einer Spezialbank, die durch die Neuausrichtung der Hypo Real Estate Group entsteht, ist offensichtlich.”] Likewise, see BayernLB, Annual Report 2008, p. 28: “But new refinancing options for banks have been opened up by the new market segment of State-guaranteed bonds, and on 23 January 2009, BayernLB issued its first State-guaranteed bond [...]”

<sup>109</sup> Cf. Bremer Landesbank, press release of 17 November 2011: “Bremer Landesbank expected [a rating downgrade] since the calculations were based on the global assumption that the support of the controlling entities could, as a whole, decrease.” [“Die Bremer Landesbank hat [ein Downgrade im Rating] erwartet, weil die Berechnungen auf der globalen Annahme basieren, dass die Unterstützung der Träger insgesamt abnehmen könnte.” Unofficial translation.] At the time this press release was published, the institution did not benefit from explicit State liability guarantees anymore.

<sup>110</sup> Co-CEO Fitschen, as cited in: Osman, Y., Fitschens Klartext, Handelsblatt, 18 November 2013.

**1412.** It is a central lesson of the financial crisis that regulation must in any event be directed to take the implicit guarantees away from the benefiting undertakings and to abolish them altogether. The implicit guarantees can in principle be abolished through competition law or prudential measures.

However, the competitive advantage associated with an implicit guarantee eludes existing competition law. Competition law (antitrust law) concerns advantages accruing to companies because they can expand or exploit their individual or common scope for conduct on the market in a way that cannot be challenged by other market participants. In the case of implicit guarantees, in contrast, financial market participants are able to shift the liability for their losses to the State (and, thereby, other market participants).

Implicit guarantees were not regarded as a prudential problem before the financial crisis, as the dangers to systemic stability, which are connected with the accumulation of systemic risk, were for a long time ignored. The financial crisis, however, made it clear that the financial market participants benefiting from an implicit guarantee can shift liability to States in a way that puts a significant strain on individual States or can even overburden them.

**1413.** In the financial crisis, the European Commission sought to take into account the problem of implicit guarantees in its State aid proceedings. State aid law is suited at least indirectly to address the competitive advantage associated with an implicit guarantee. As a rule, State aid law does not require any direct compensation for the implicit guarantee accruing to individual market participants. That said, it requires at least compensation for the granted State aid measures if the implicit guarantee is used. In the relevant cases, also, the European Commission required additional compensation for the distortion of competition which followed from the fact that banks with an implicit guarantee, which suffered from endogenous problems, were only able to survive during the crisis on the basis of that guarantee.

**1414.** The regulation after the financial crisis is meant to reduce the risk of State aid by neutralising existing implicit guarantees or by preventing the emergence of such guarantees. In that context, it is the primary goal of regulation to make unnecessary any State action to secure financial stability. It is no priority of the regulation so far to absorb the competitive advantages and the associated market distortion.

**1415.** The following section identifies regulatory deficits at the origin of implicit guarantees, taking the financial crisis as an example, and it evaluates the existing or planned regulation from a competition policy perspective. Moreover, the Monopolies Commission makes recommendations for developing the regulation further, taking due account of competition policy aspects.

### ***3.5 Implicit State guarantees in the financial crisis***

**1416.** The financial crisis developed in a situation where the US market for real property financing was speculatively bloated (real property bubble) and the risks emanating from that bloated market materialised in summer 2007. At the beginning, the crisis centred only on mortgage securities.<sup>111</sup> When the crisis developed further, however, threats to the national and the global financial system quickly emerged, which forced the EU Member States to save banks considered to be systemically relevant from distress. In that context, implicit guarantees were utilised to a significant extent.

**1417.** The fact that banking regulation in the EU and Germany was not risk adequate was merely one cause for the development of systemic risk. In addition, other factors in the United States (the liberalisation of the financial market, intensive housing subsidies over a longer period, loose monetary

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<sup>111</sup> According to estimates of the International Monetary Fund (IMF), until October 2008, the drop in value in this business alone was approx. USD 500 billion in sub-prime mortgages and approx. USD 80 billion in prime mortgages.

policy) as well as in Europe (inadequate business focus of the banks; in Southern Europe: conditions for joining the euro area) contributed to the development of such risk. The materialisation of the risk and the quick development of a systemic crisis, then, had a number of causes, including:

- the opacity and information asymmetries as a general market problem,
- trend-led and pro-cyclical herding of the market participants,
- catastrophe blindness and a disposition to shift the risk (negative externalities), and
- the direct reflection of value losses (e.g., because of fair value accounting).

Some of these causes reflect non-rational market behaviour (or confidence or the loss on confidence in such behaviour), and were disregarded for a long time by leading economic doctrine.<sup>112</sup>

**1418.** In the context of this report, particular interest is placed on the shortcomings of bank regulation, which became apparent during the crisis. The shortcomings of regulation not only fostered the accumulation of systemic risk, but they also allowed one to infer competition-policy recommendations for measures for neutralising and hindering the development of implicit guarantees (cf. Section 3.5.1). In addition, however, the crisis also demonstrated the high cost for the national economy, which may be associated with the use of the guarantees if no risk adequate regulation exists (see Section 3.5.2). Finally, as regards the regulatory measures adopted or discussed as a reaction to the use of implicit guarantees during the crisis, the European Commission's State aid principles for the evaluation of bank rescue measures in the crisis provide some indications of how future financial market regulation should be designed to effectively neutralise or hinder the development of implicit guarantees (see Section 3.5.3).

### ***3.5.1 The development of implicit guarantees***

**1419.** In the run-up to the financial crisis, regulatory deficits and the existing market conditions worked together fatefully, hindering banks with a business burdened with systemic risk from leaving the market, at the same time furthering the business with high systemic risk, and hindering other market participants from becoming aware and evaluating the systemic risk. As to the relevant deficits of regulation, thus, the following three types of causes for implicit guarantees can be distinguished:

- First, regulation fostered the development of company structures contributing to the emergence of implicit guarantees.
- Second, the concentration of systemic risk at these institutions was fostered because regulation benefited or at least tolerated the taking on of business at these institutions, which was risky and could threaten their survival.
- Third, the business environment was marked by regulatory opacity and large information asymmetries regarding the relevant risk.

A peculiarity in the German financial system is the situation of the *Landesbanken* and Hypo Real Estate, which are addressed separately below.

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<sup>112</sup> This could also affect current regulation, see, e.g., Lux, T., Effizienz und Stabilität von Finanzmärkten: Stehen wir vor einem Paradigmenwechsel?, [2013] Wirtschaftsdienst Sonderheft, pp. 16-22; Dullien, S., Umbau der Finanzmärkte: Übermäßiges Vertrauen in Marktrationalität hält an, [2013] Wirtschaftsdienst Sonderheft, pp. 23-29.

### 3.5.1.1 *Preferential treatment for company structures contributing to implicit guarantees*

**1420.** The emergence of company structures benefiting the development of implicit guarantees was fostered from the outset by the lack of a resolution mechanism for systemically relevant banks, and thus by the lack of a market-adequate sanctioning mechanism for the acceptance of excessive risk. Even though insolvency rules existed in the relevant jurisdictions, they were considered to be inadequate for the resolution of banks even before the crisis.

**1421.** Likewise, no security system existed for all suppliers of risk-associated financial products, i.e., a system that could have operated as an insurance against the materialisation of systemic risk. The statutory deposit guarantee scheme was insufficient to protect depositors when the crisis erupted.

**1422.** In addition, multiple financial market participants existed that operated one-sided business profiles without adequate risk management, and that participated in the business with problematic mortgage securities and, thus, accumulated systemically relevant risks. The participation of these undertakings took place throughout the distribution chain, particularly because of the capital rules that existed at the time – which are discussed separately below.

Mainly US investment banks operated at the most upstream level, i.e., institutions with a business focus in the trade with securities, which had developed within the US dual banking system. Given the fast-growing US real property sector, it became attractive for these banks to securitise mortgage loans of relatively weak debtors and to market these so-called sub-prime securities.

On the buy side, particularly investors with speculative interests participated in the securities business on the sub-prime market, for example, short-term oriented investors such as money market and hedge funds. This group of speculative investors, however, also included banks. These banks were either universal banks or institutions with specialised business models, for instance, particularly investment banks in the Anglo-American region. That said, it is striking that also in Germany, which has a universal banking system, not only the large commercial banks (Dresdner Bank/Commerzbank, Deutsche Bank) participated – sometimes to a large extent – in the business with US sub-prime securities. To the contrary, here as well, many banks with relatively narrow business profiles took an interest in engaging in that business. These banks included special private banks such as IKB, which used short-dated sub-prime securities for refinancing purposes, but also the *Landesbanken* and the head institutions of the savings bank group and the cooperative group, which acted as the central banks of the two associated banking groups.<sup>113</sup>

**1423.** The large differences between banking regulation and the regulation of non-bank entities are a factor that provided significant incentives for the participation of inadequately regulated institutions and organisms in the securities business.

In particular, the banks themselves used organisms that did not fall under bank regulation. For instance, on the side of mortgage securities issuers, it was attractive to use so-called Special Purpose or Special Investment Vehicles (SPVs/SIVs; Conduits)<sup>114</sup> as this made it possible to shift the risk of default associated with the mortgage loans away from the issuer. Also as investors, banks used SIVs to purchase long-dated securities without assuming the associated risk of default. The relevant SIV operated practically with only very little or no capital. The controlling banks issued liability

<sup>113</sup> As to the public banks' share of liability for the crisis, see from the EU's perspective, e.g., High-Level Expert Group on reforming the structure of the EU banking sector (Liikanen Commission), Final Report, 2 October 2012; further, from the perspective of German authors, Demary, M./Schuster, T., *Die Neuordnung der Finanzmärkte. Stand der Finanzmarktregulierung fünf Jahre nach der Lehman-Pleite*, IW Analysen No. 90, August 2013. As to the *Landesbanken*, see also Section 1.1 below.

<sup>114</sup> Cf. § 1(26) of the Banking Code (*Kreditwesengesetz – KWG*), § 231(2) of the Solvability Regulation (*Solvabilitätsverordnung – SolvV*); further § 290(2) No. 4 of the Commercial Code (*Handelsgesetzbuch – HGB*).

guarantees for the SIV, but they had to back these guarantees with less capital than what would actually have been necessary regarding the mortgage loans. The German banks belonged to the group of European banks that operated the largest SIV.<sup>115</sup>

Apart from that, further non-banks (shadow banks) participated to a large extent in the securities business, i.e., money market and hedge funds. This was no business, though, where private equity companies were active. These, so it appears, did not suffer problems threatening systemic stability during the crisis either.

### 3.5.1.2 *Preferential treatment for business potentially threatening systemic stability*

**1424.** It became apparent during the crisis that regulation furthered and supported business transactions that potentially threatened the system. The difficulty, however, lies in the determination of the extent to which individual regulatory deficiencies indeed contributed to the financial crisis. This Report can only provide a rough overview in that regard.

**1425.** A problem that became acute as the crisis gathered speed (pro-cyclicality) consisted in liquidity risk associated with maturity transformation in the case of securities products. The securitisation of mortgage loans should theoretically allow for transferring the risk from long-dated mortgage securities to investors with a long-dated investment horizon, and thus being better prepared to bear the risk than the mortgage debtors or the banks accepting the mortgage. In reality, however, also many short-term investors engaged in this business.<sup>116</sup> These investors quickly withdrew large amounts of liquidity when problems arose on the securities markets. This led to a squeeze not only on the securities markets, but the entire trade in short-dated obligations dried up to a large extent in parallel.

**1426.** Another problem ensued from the fact that insufficient capital was used to back the risk provisions for the business affected by the crisis, and that the banks used much borrowed capital beside their own capital in order to increase the capital return of their investments (“leveraging”).

The banks’ own capital is a directly available buffer for the risks of the relevant business. Nevertheless, the capital requirements were very low before the financial crisis. Regulatory incentives for the use of SIVs, for securitisation, and for the use of CDS resulted from the fact that the capital requirements contained loopholes for these instruments.

Leverage is an essential component of the banking business because it enables a bank to provide credit beyond the amount of deposits it holds and to create thereby the money needed in the economic system. Within the framework of the US mortgage loan and securities business, however, the low capital requirements made it attractive to make excessive credit offers and to supply credit excessively and to expand the business using third-party capital. In Germany, this applied particularly to banks with special profiles that were, hence, active outside traditional banking from the outset, or to banks that were universal banks, but whose traditional business yielded particularly low profits due to the savings banks’ and the cooperative banks’ nationwide market coverage and the recession in Germany in the years from 2001 to 2005 (*Landesbanken*, private banks).<sup>117</sup> This situation led the relevant banks to expand their lending substitution activities and to purchase securities abundantly.<sup>118</sup> Sachsen LB

<sup>115</sup> Cf. Acharya, V.V./Schnabl, P., Do Global Banks Spread Global Imbalances? Asset-Backed Commercial Paper during the Financial Crisis of 2007-09, [2010] IMF Economic Review 58(1), pp. 54-55.

<sup>116</sup> Investment banks, money market and hedge funds; see above, para. 1422.

<sup>117</sup> Cf. Deutsche Bundesbank, Zur jüngsten Entwicklung der Kredite deutscher Banken an inländische Unternehmen und Privatpersonen, Monthly Report, July 2006, pp. 15 ff. In individual cases, also other aspects play a role, e.g., in the case of SachsenLB: an insufficient basis of large customers; HRE: ambitious growth strategy.

<sup>118</sup> Cf. Admati, A./Hellwig, M., The Bankers’ New Clothes, Princeton 2013, p. 84; Lindner, F., Banken treiben Eurokrise, IMK Report No. 82, June 2013.

disposed of investment products valued at EUR 39 billion, but had only EUR 1.4 billion in capital in mid 2007.<sup>119</sup>

Another problem was that capital regulation allowed banks to use their own risk weights, the appropriateness of which was difficult to judge from the outside. The risk models could generally not capture all risks in an adequate fashion as essential information was missing, for instance, information on systemic risks. The problem persists today. No limitations existed for providing credit independent of the amount of leverage.

**1427.** In particular regarding mortgage securities, the banks also had further leeway regarding the underlying capital, this leeway following from the design of the products in the individual case. Securities purchased by another entity – including an SIV – could be held in the trading book. Therefore, the securitised loans had to be backed by capital only to insure against price risks. In contrast, no capital backing was required with regard to credit risks. Thus, the capital backing was lower than in the case of other loans that had to be kept in the investment book (banking book).<sup>120</sup> Where institutions securitised mortgage loans themselves, the credit risk had to be taken into account, but it could be squared in the bank’s risk model if the bank had contracted with a credit insurer that it took over the credit risk (CDS transaction).<sup>121</sup>

**1428.** This made it possible to reserve significantly less capital for asset-backed securities than would actually have been necessary in view of the risks associated with these products. The relevant financial products were, in essence, the following products:

- Asset Backed Securities (ABS): These consist in securities or bonds that securitise payment claims towards an SIV and that are collateralised by a pool of similar claims (asset portfolio/assets).<sup>122</sup> In the case of true ABS, it is not possible to take recourse to the seller of the securities, which it has transferred to the SIV (“true sale”). Mortgage backed securities (MBS) form a subgroup of ABS collateralised using mortgages.
- Synthetic products (derivatives): These are financial instruments that are constructed for financial –not physical – performance, the point of performance being shifted to a pre-defined point in time.<sup>123</sup> They have a “derivative” character because their price is derived from or dependent on the price of other products.<sup>124</sup> This makes it possible to shift risk independently from the underlying transactions. If ABS are structured as derivatives, only the default risks from the asset portfolio are transferred to the SIV instead of securities (synthetic ABS).<sup>125</sup>
- Combinations of securities and synthetic products (structured financial products): This group encompasses, for example, bonds with an added-on credit default insurance (“credit default swap”<sup>126</sup>), such as credit linked notes (CLN). In these cases, the issuer has the obligation to pay the bond and to pay a premium to the seller of the CDS (the investor). Apart from that,

<sup>119</sup> Cf. Balzli, B./Schiessl, M./Winter, S., Casino provincial, Der Spiegel 28/2008, p. 8.

<sup>120</sup> § 1a(2) KWG.

<sup>121</sup> Hellwig in: Hellwig/Höfling/Zimmer, Gutachten E/F/G zum 68. Deutschen Juristentag, supra, p. E 33.

<sup>122</sup> The claims in the pool can themselves be securitised or collateralised, or not; for the details, see Jahn in Schimansky/Bunte/Lwowski, Bankrechts-Handbuch, Band II, 4th Ed., Munich 2011, § 114a paras. 1 ff.

<sup>123</sup> In spite of the common classification as a “time deal”, it is accepted that derivatives do not require a base value (“underlying”) with market value; cf. Federal Court of Justice (*Bundesgerichtshof* – BGH), Judgment of 31 October 1998, XI ZR 26/98, [1998] WM 2331, para. 20 (citation: Juris).

<sup>124</sup> The instrument is called “exotic” if it deviates from a standard derivative (e.g., because it requires simulations).

<sup>125</sup> The instrument is “synthetic” because no transfer of securities takes place.

<sup>126</sup> The “swap” element is that the owner of the obligation pays a fixed sum to the counterparty. In case of a default of the obligation, the counterparty must purchase the relevant security from the owner. A payment obligation regularly only exists for the actual difference (“netting”), which is why derivatives such as CDS are also called margin trading (“*Differenzgeschäfte*”).

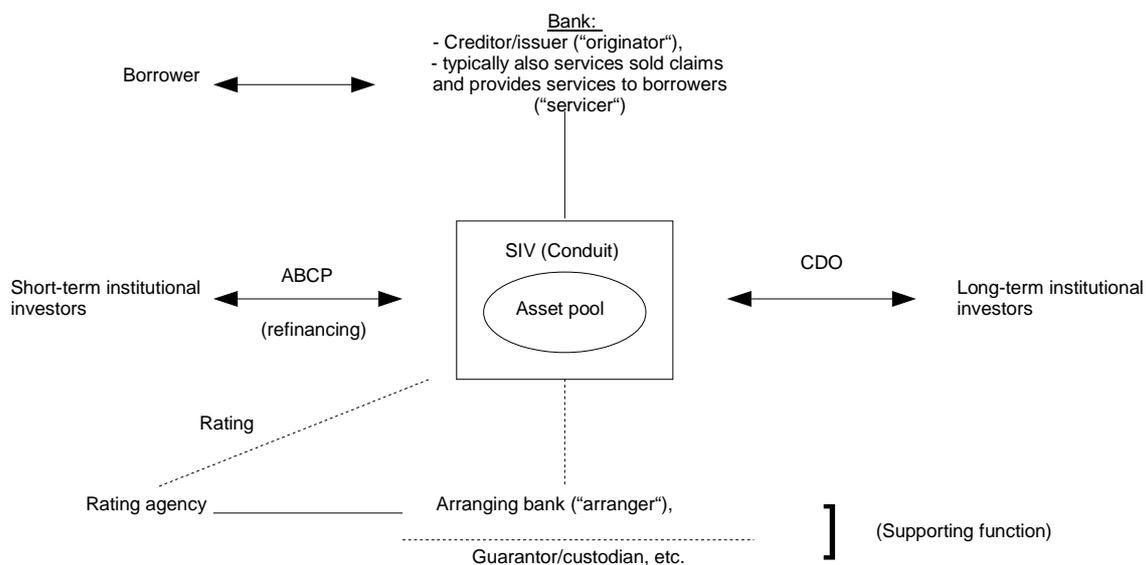
also other structures, sometimes purely synthetic, products play an important role, for example combinations from interest swaps and CDS (“Total Return Swaps” – TRS/TRoRS).<sup>127</sup>

The financial products above were often issued in tranches of differing credit standing. The better “senior” tranche was served with priority over the “junior” tranche(s). The latter absorbed the losses and were accordingly furnished with a better right to claim interest (coupon).

**1429.** ABS were used as investment products and for refinancing purposes in the context of the crisis-relevant business. The employed SIVs funded themselves by means of short-dated ABS, i.e., asset-backed money market securities (“Asset-Backed Commercial Papers” – ABCP). The longer-dated ABS that they issued to the investors could be covered by loans or bonds (“Collateralised Debt Obligations” – CDO).<sup>128</sup> In the case of CDO, the SIV retained the securities and only sold the cash flows from these securities (e.g., payments of interest and principal). The market for CDO expanded enormously in the years before the crisis. Prior to 1996, the trade only consisted of CDO in the amount of roughly USD 5 billion, but by 2006, the volume had risen by 7700% to USD 388 billion.<sup>129</sup>

**1430.** The structure for establishing or investing in a self-refinancing securities business without capital contribution can be sketched out as follows:

**Figure VI.1: Structure of a securities business**



Source: own illustration.

**1431.** Further, substantial incentives existed for the acting employees – on the sellers’ and on the buyers’ side – to develop the securitisation business to their own advantage, and to expand it excessively:

- Remuneration incentives to achieve higher profits by entering into corresponding risk (bonus systems); in conjunction with
- Incentives to break rules given the lack of personal sanctions and opportunities to shift materialising risk (lack of deterrence).

<sup>127</sup> Total (Rate of) Return Swaps are credit derivatives where the earnings and the fluctuations in the value of the underlying financial instrument are swapped against fixed payments of interest.

<sup>128</sup> Depending on which asset is used as underlying, two groups can consequently be distinguished: “Collateralized Loan Obligations” (CLO) and “Collateralized Bond Obligations” (CBO).

<sup>129</sup> Cf. Balzli, B., et al., Der kranke Gorilla, Der Spiegel 5/2008, 28 January 2008.

In this context, they used their alleged superior knowledge to their own benefit, without regard to potential consequences for the respective institution (principal–agent problem).

### 3.5.1.3 A business environment impaired by opacity and information asymmetries

**1432.** The business environment marked by opacity and information asymmetries constituted another problem that led to the creation and finally to the materialisation of systemic risk. The opacity resulted to a large extent from the sub-prime products themselves and their use for speculative purposes.

**1433.** ABS are used to invest in the securitised rights and not necessarily for speculative purposes. They enable the trade in products with limited fungibility, for instance, long-dated mortgage obligations. This trading opportunity, however, can also be used by investors with a short-term investment horizon in order to acquire ABS for primarily speculative purposes. This may be accepted if the investors understand the sometimes very complex products and the associated risk. The ABS securitising the relevant mortgage products, however, were often highly complex products (e.g., due to multiple securitisations) whose risk profile one could not calculate.

**1434.** The use of financial derivatives must be regarded as being even more problematic in the present context. Derivatives are often not traded on the market, nor are they investment products since they have no underlying with a market value. This even holds when the claims resulting from a derivative are transformed into securitised claims. The essential function of derivatives is to transfer risk, and they can consequently be used to hedge risks, or for speculation.<sup>130</sup> Even where the acquirer of a derivative has to compensate for an initial negative margin, it does not pay a “purchase price” in the legal sense for the financial instrument, i.e., a price that the supplier of the derivative can ask for as consideration. Rather, the negative margin only transfers the chances of financial gain or the risk of loss away from or to the customer in case a risk materialises.<sup>131</sup> The right to claim performance only arises when the risk being the object of the derivative has materialised to one of the parties’ benefit (then, one claim is executed to the advantage of the beneficiary; “pay-off”). The operation has the character of a financial bet, in accordance with the meanwhile abrogated § 764 of the Civil Code (*Bürgerliches Gesetzbuch* – BGB), which was correct in that respect, since the risk is the object of the operation and since the probability of whether the risk materialises is only fortuitous and dependent on the available information (“statistical causation”).<sup>132</sup> The risk of derivatives for investors does not follow from imbalances in the setting of contractual claims either (impaired equivalence), but from the object of the contract itself, i.e., the risk allocated to both parties, the materialisation of which depends on probabilities alone.<sup>133</sup> Regarding the derivatives that were relevant in the financial crisis, the risk

<sup>130</sup> Due to that core function of derivatives, potential delivery obligations play a secondary role and will remain out of consideration in this context.

<sup>131</sup> The shift of risk takes place to put the supplier of the derivative in the position of a seller (similar: agreement on a commission). Thus, the supplier should be obliged to disclose that the initial present value is negative – like a seller would have to disclose the price; cf. BGH, Judgment of 22 March 2011, XI ZR 33/10, BGHZ 189, 13, head note No. 3 and paras. 31, 33 (citation: Juris) with comments by Schmieder, WuB I G 1. – 16.12.; Higher Regional Court (*Oberlandesgericht* – OLG) of Stuttgart, Judgment of 26 February 2010, 9 U 164/08, [2010] WM, 756, para. 5.

<sup>132</sup> § 764 of the Civil Code (*Bürgerliches Gesetzbuch* – BGB), as repealed, read as follows: “Where a contract on the delivery of goods or securities is formed with the intention that the losing party shall pay the winning party the difference between the agreed price and the exchange or market price, the contract shall be considered to be a game [...]” [Unofficial translation of “Wird ein auf Lieferung von Waren oder Wertpapieren lautender Vertrag in der Absicht geschlossen, daß der Unterschied zwischen dem vereinbarten Preise und dem Börsen- oder Marktpreise der Lieferungszeit von dem verlierenden Teile an den gewinnenden gezahlt werden soll, so ist der Vertrag als Spiel anzusehen. [...]”.] The provision was deleted in view of the legal consequences foreseen in § 762 BGB.

<sup>133</sup> Speculating on a winning chance is an essential element of derivatives; see Reichsgericht, Judgment of 17 December 1928, V 314/33, RGSt 415, 416.

was frequently leveraged, exponentiating the chances of profit and the risk of loss, which made re-margin payments necessary beyond the original commitment. In addition, speculative use was made of swap transactions, which were used to swap the risk of interest changes. These products were very complex from the outset and were frequently based on risk assumptions that sometimes turned out to be incorrect in the financial crisis.

**1435.** In view of the complexity of the relevant markets and products, competitors and buyers were not able from the outset to act in the interest of market discipline and to cause the suppliers to offer products with a comprehensible risk profile. However, the already described shortcomings existed also at the other market participants in the same form all the way down the distribution chain. On the buyer's side as well, no sufficient incentives existed to require that the purchased sub-prime financial products be structured with a comprehensible risk profile. For the buyers' purchase interest, it was decisive at least in the years up to 2006 that the increasing quality issues with the sub-prime products were counterbalanced by the increase in US real property prices and the associated profit expectations. This had as a consequence that also European buyers engaged to a large extent in US mortgage securities although they did not understand the market and were in no position to understand it either. This engagement continued down to the level of end-customers, who likewise acquired such products (e.g., certificates). Buyers turned a blind eye to the principle that high-yield expectations come along with high risk. It is estimated that European buyers bought roughly one quarter of the securities traded on the US sub-prime market.

**1436.** No other mechanisms effectively substituted for the control by other market participants. The self regulation of the financial industry did not operate correctly given the prevailing interests. The rating agencies accepted the implicit guarantees as a given fact. Due to the information asymmetries regarding the relevant financial products and due to the fact that they were paid remuneration by the product issuers, they did not have incentives to review the risk profile of the products in detail. In addition, the rating agencies were not subject to considerable liability for wrong rating estimates according to the applicable jurisprudence. The public financial market authorities were likewise not able to remedy these deficiencies, already given the fact that the traded products were also complex for the authorities, and because the market developments could barely be assessed.

#### **3.5.1.4 The particular situation of the Landesbanken**

**1437.** The participation of public banks in the business with US sub-prime securities, which was at the core of the crisis, was a German particularity. The *Landesbanken* – but also some major savings banks – had engaged in sub-prime securities to a particularly large extent within the German financial system. It is by no means by accident that these public banks were active in the business with sub-prime securities in greater numbers than private and cooperative banks.

**1438.** The public banks' investment in US sub-prime securities had a deeper cause in substantial competition distortions to the advantage of these banks, which had to be removed following a settlement with the EU in 2001 (the so-called Brussels Concordance).<sup>134</sup> This meant the abolition of unlimited express State liability for the obligations of public banks that were organised as public institutions (*öffentliche Anstalten*) (the so-called *Anstaltslast* and *Gewährträgerhaftung*). Due to this State liability, the relevant banks had enjoyed an advantageous rating, and consequently significant refinancing advantages. It was estimated that these advantages amounted to between 19 and 69 basis points.<sup>135</sup> The settlement with the EU stipulated in principle that the *Anstaltslast* component be

<sup>134</sup> European Commission, press release of 28 February 2002, IP/02/343; Decision of 27 March 2002, E 10/2000, Germany. *Anstaltslast und Gewährträgerhaftung*.

<sup>135</sup> Cf. Berge, K./Berger, R./Locarek-Junge, H., *Deutsche Landesbanken: Status Quo und Strategien vor dem Hintergrund des Wegfalls der Staatsgarantien*, [2006] DIW Vierteljahreshefte zur Wirtschaftsforschung 75(4), p. 76.

aligned with the so-called market investor principle, and that the *Gewährträgerhaftung* component be abolished altogether. Thereby, the liability for public banks should be aligned with an owner's liability for private banks as far as possible. The relevant banks were granted a transitional period in which to reorganise their business until 18 July 2005; afterwards, only existing obligations were allowed to be covered by the State liability guarantees, and only until the end of 2015.

**1439.** The looming disappearance of the competitive advantage associated with the liability guarantees caused notably the *Landesbanken* to take up much fresh capital on the financial markets until 2005. In contrast to the savings banks, which were able to reorganise their business rather easily according to the obligations under the Brussels Concordance, the *Landesbanken* pursued a business model that depended greatly on good ratings by the rating agencies, but that was often not associated with steady customer relationships (large corporate banking, investment banking). Thus, a deterioration of the rating was immediately followed by a loss of customers. It was, however, an obstacle to reorienting the *Landesbank* business that the savings banks were able to enforce a work division through their associations, which to a large extent barred the route into retail banking for the *Landesbanken*.<sup>136</sup> Consequently, the *Landesbanken* found themselves on the horns of the dilemma of having much excess liquidity without having a robust business model.<sup>137</sup>

**1440.** This provided significant incentives to the German *Landesbanken*, in particular, to engage in business in hazardous business areas where high risk promised high yields, including the US sub-prime market. The savings banks participated to some extent in these activities within the context of the savings bank group, of which both the *Landesbanken* and the savings banks are members. These activities were generally not in line with a special mandate of the public banks, however that may be defined. They were possible because all the financial market participants succumbed to a certain unscrupulous way of thinking with regard to risk that could not be quantified. In addition, political representation was frequent on the public banks' management boards (which it still is today), and the representatives were often not sufficiently competent for their job.<sup>138</sup>

### 3.5.1.5 *The critical case of HRE*

**1441.** The case of Hypo Real Estate (HRE) is another peculiar case in the German financial system – which is also singular in its economic effects. HRE's business model was based on granting high-interest, long-dated loans that were refinanced through short-dated loans (especially commercial real property and infrastructure loans). To a large extent, long-dated loans were also granted to States, and consequently had to be backed with very little capital – as is still the law.<sup>139</sup> HRE was moreover active in issuing *Pfandbriefe* (German covered bonds), a business closely related to commercial real property financing. Securities were not a main field of activity; however, HRE depended extremely on the confidence in the functioning of the money markets and financial markets due to its refinancing structure. To conduct its credit business, HRE used a subsidiary in Ireland, which had relatively light regulation. The German prudential regulator had no overview of the actual risk of HRE's entire business. The risk was apparently not made public and not sufficiently evaluated by the rating agencies either.<sup>140</sup> If that had been the case, it appears that it would generally have been foreseeable that HRE was due to quickly enter into distress in the financial crisis, and thus threatening its existence.

<sup>136</sup> This division of tasks itself raises competition concerns. See Section 4.3.3.

<sup>137</sup> Cf. OECD Bank Profitability Database: performance even worse than average German bank; <http://stats.oecd.org/Index.aspx?DataSetCode=BPF1>; accessed: 24 June 2014.

<sup>138</sup> In this context, see Section 4.6.2; further Hau, H./Thum, M., Subprime Crisis and Board (In-) Competence: Private Versus Public Banks in Germany, [2009] Economic Policy 24(60), pp. 701-752.

<sup>139</sup> Cf. Hypo Real Estate Group, Annual Report 2007.

<sup>140</sup> HRE benefited of high ratings with a stable or positive outlook until the end of 2007; see Hypo Real Estate Group, Annual Report 2007, p. IV.

### 3.5.2 Use of implicit guarantees and market result

**1442.** Implicit State guarantees were used when the systemic risks stemming from the business with US mortgage securities materialised. It was only at this point that they obtained their actual – and basically priceless – value. In this context, it should be noted that implicit guarantees were also called upon by institutions whose systemic relevance may be questionable from today’s perspective.<sup>141</sup> This, however, was due to the lack of possibilities for politicians and market participants to correctly appraise potential systemic relevance in advance, and the firm belief in the view that individual banks in distress actually had to be systemically relevant. This view was obviously not called into question by the relevant institutions. If anything, there was an interest to shift the blame for one’s own problems to the politicians and other market participants that had not been early enough to denounce another culprit (e.g., to HRE, the *Landesbanken*, etc.).<sup>142</sup>

**1443.** The existence of implicit guarantees forced German politicians to support IKB Deutsche Industriebank and SachsenLB and, after the Lehman Brothers collapse in 2008, HRE, Commerzbank and most of the other *Landesbanken* (WestLB, BayernLB, HSH Nordbank, LBBW) in quick succession.<sup>143</sup> This aid was supplemented by more general measures (“State aid schemes”) to support financial institutions, and by measures which the security schemes of the banking industry adopted on their own; the security scheme of the private banks having itself to be recapitalised through State aid as the situation developed. Moreover, the financial stability fund (SoFFin) was created with the task of providing means for the acquisition of defaulted or near-to-default assets and for the recapitalisation of financial institutions.<sup>144</sup> Other EU Members States took similar measures to support their own banks.

**1444.** The capital need for these support measures was considerable throughout the European Union. According to the European Commission, roughly EUR 5.09 trillion (EUR 5,085,960,000,000) was provided in the form of guarantees, liquidity support, or capital for bank rescue measures in the entire Union between October 2008 and October 2012 (equalling 40.3% of EU GDP).<sup>145</sup> Out of this total,

<sup>141</sup> See above, para. 1398: In these cases, systemic relevance should have evolved already from the impression that the banks were systemically relevant and that their collapse would send a fatal signal to the market. In this context, see also BaFin, memorandum of 8 October 2009: Zusammenfassung der Gespräche zur Stützung der Hypo Real Estate Gruppe (HRE) vom 26.09.2008 – 28.09.2008 am Frankfurter Dienstsitz der BaFin, <http://www.ftd.de/politik/deutschland/:protokoll-zur-hre-rettung-ackermann-fuehrt-aus-dies-sei-der-tod/537077.html> (no longer accessible).

<sup>142</sup> As to the allocation of responsibility, see, e.g., 2nd Committee of Inquiry of the 16th Legislative Period (HRE Committee), Status Report of 18 September 2009, BT-Drs. 16/14000; U.S. Senate, Permanent Subcommittee on Investigations, Wall Street & The Financial Crisis: Anatomy of a Financial Collapse, Report of 13 April 2011.

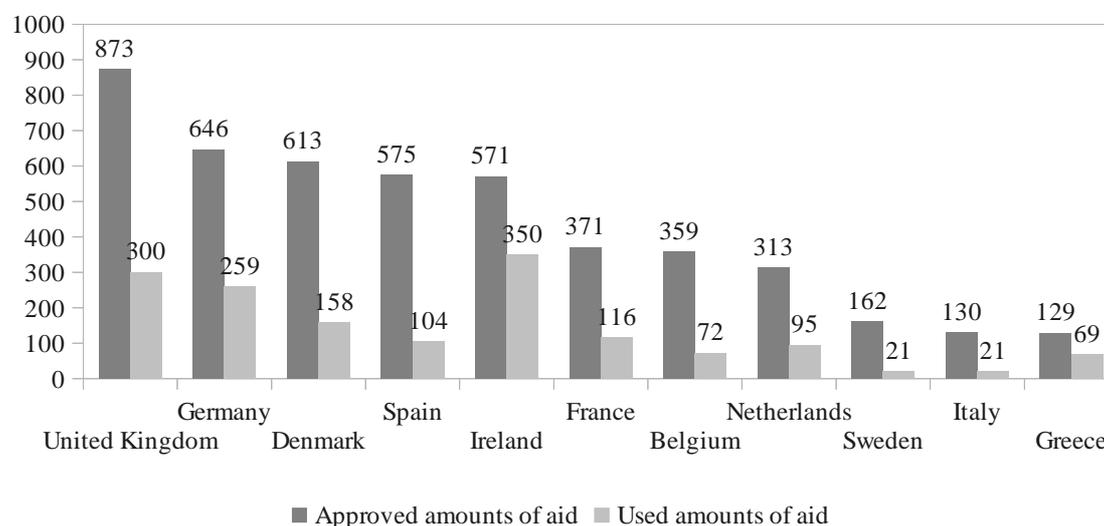
<sup>143</sup> See European Commission, MEMO/13/337 of 16 April 2013 on the State aid decisions adopted from 2008 to the (then) present. The recapitalisation of Nord/LB in the same time period was not directly related to the crisis, but stands in a context with the increased capital requirements under Basel III. No aid has been requested so far by Hessische Landesbank (Helaba).

<sup>144</sup> See, e.g., European Commission, Decision of 27 October 2008, N 512/2008, Germany. Rescue package for credit institutions in Germany; Decision of 31 July 2009, N 314/09, Germany. German asset relief scheme for impaired assets; Decision of 21 January 2009, N 17/2009, Germany. SoFFin - Guarantee for the German deposit guarantee scheme for private banks – Germany. The savings bank group refused the use of its security system for the rescue of the *Landesbanken*; see European Commission, Staff Working Document of 12 July 2010, SEC(2010) 834/2, Impact Assessment accompanying a Proposal for a Directive on Deposit Guarantee Schemes [recast], p. 24.

<sup>145</sup> European Commission, Facts and figures on State aid in the EU Member States, Staff Working Document – Autumn 2012 Update –, 21 December 2012, {COM(2012) 778 final} = SEC(2012) 443 final, pp. 29 ff.; corrected: Federal Government, Bericht der Bundesregierung über die Entwicklung der Finanzhilfen des Bundes und der Steuervergünstigungen für die Jahre 2011 bis 2014 (24. Subventionsbericht), BT-Drs. 17/14621, 19 August 2013, p. 42. The aid element is not identified specifically in the mentioned documents; cf. European Commission, *ibid.*, p. 52. Hence, it is not reproduced throughout this section.

EUR 3,394 trillion was approved as State aid in 2008 alone. The approved and the used State aid for German banks was EUR 646 billion and EUR 259 billion, as can be seen in the following illustration:

**Figure VI.2: State aid by selected EU countries for bank rescue measures (in billion Euro; > EUR 100 billion) from 1 October 2008 to 1 October 2012 (approved) or to 31 December 2011 (called upon)**



Source: own illustration on the basis of European Commission, Facts and figures on State aid in the EU Member States, Staff Working Document – Autumn 2012 Update

**1445.** The following table breaks down the volume of the individual State aid measures for German institutions. According to it, most of the approved aid consisted in guarantees with EUR 456 billion, EUR 135 billion of which was also called on. In addition, recapitalisation and asset relief measures with a large volume were approved and called upon. In contrast, the measures for liquidity support were relatively small.

**Table VI.1: Amount of State aid measures for the benefit of German banks**

State aid measures	Approved (01.10.2008 – 01.10.2012)		Called upon (01.10.2008 – 31.12.2011)	
	in EUR bn	in % of GDP in 2011	in EUR bn	in % of GDP in 2011
Recapitalisation	114.61	4.5	63.24	2.46
Guarantees	455.85	17.7	135.03	5.25
Asset relief measures	66.10	2.6	56.17	2.19
Liquidity measures	9.50	0.4	4.75	0.18
Total	646.06	25.1	259.19	10.08

Source: European Commission, Facts and figures on State aid in the EU Member States, Staff Working Paper Autumn 2012 Update

**1446.** It must be assumed that a major part of the State aid was provided to banks benefiting from implicit State guarantees. As far as can be seen in the decisions, the European Commission typically did not regard the institutions to be supported with aid particularly at the peak of the financial crisis,

until spring 2009, as “fundamentally sound”, but rather as “suffering from endogenous problems”.<sup>146</sup> In this context, “fundamentally sound” institutions had a generally balanced business and risk profile, and were only in distress due to the particular situation in the financial crisis. Institutions with “endogenous problems”, by contrast, pursued business activities that were unbalanced to a higher degree. The fact that these institutions were meant to be kept on the market through State aid is a direct indication that they benefited from implicit guarantees. It is not possible to isolate from the granted aid the additional cost specifically associated with the banks’ ability to use their implicit guarantees. The reason is that it could remain unclear in the individual case to what extent a bank was suffering from endogenous risks or to what extent also the “fundamentally sound” business was affected as well. That being said, it must also be taken into consideration that the market distortion through implicit guarantees was also reflected in the danger that, if they failed, institutions burdened with systemic risk would also ruin “fundamentally sound” institutions. It anyway suffices to retain the fact at this stage that the ability to use implicit guarantees was supposedly reflected – at least among others – in the amount of aid granted.

**1447.** The approved aid was in fact called upon only to a limited extent. However, support measures were not subject to State aid assessment if the State rendered the support as the bank’s owner in accordance with the principles of the private market investor test. The extent to which such “clandestine” support took place (e.g. at the level of the primary institutions of the savings bank group) must be left open.

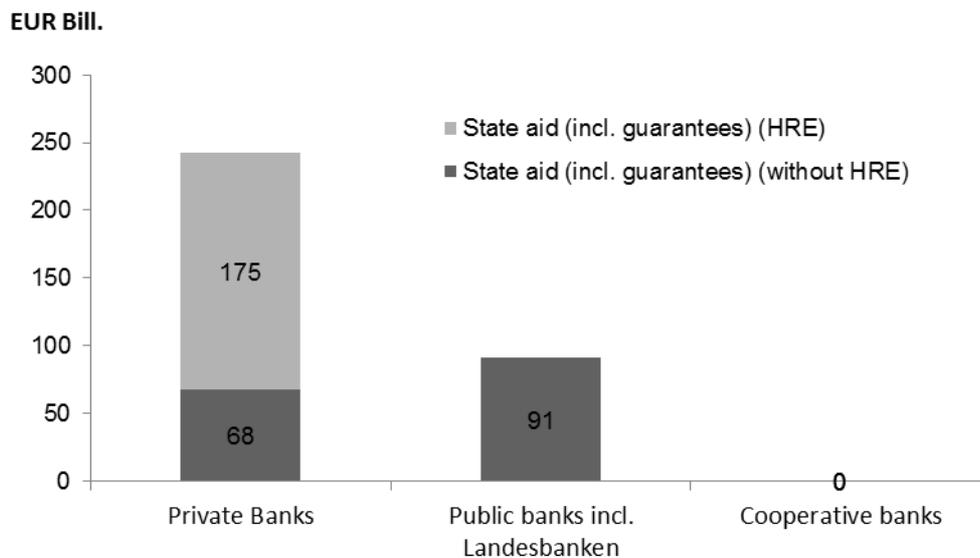
**1448.** The European Commission’s State aid decisions show the approved State aid for individual banks and for the respective security schemes, but no support provided by the security schemes, which did not itself have to be notified. That said, the Commission’s positive State aid decisions and the publications of the Federal Agency for Financial Market Stabilisation (Bundesanstalt für Finanzmarktstabilisierung – FMSA) concerning the SoFFin support measures provide an approximate view of the extent to which the three pillars of the German banking system benefited from approved State aid:<sup>147</sup>

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<sup>146</sup> Particularly the far-reaching restructuring conditions to which the approvals of State aid were typically subject may be evidence of such problems; see, e.g., European Commission, Decision of 21 September 2008, C 10/2008, Restructuring of IKB; European Commission, Decision of 12 May 2009, C 43/2008, Germany. Restructuring of WestLB AG; European Commission, Decision of 18 July 2011, SA.28264 = C 15/2009, Germany. State aid for the restructuring of Hypo Real Estate. In that context, see also para. 1461.

<sup>147</sup> This comprises the State aid approved by European Commission decisions, not measures to fund SoFFin or by security systems if the European Commission did not assess those measures also as State aid to selected institutions. The European Commission classified SoFFin measures to the benefit of individual institutions as State aid if a private market investor would not have been expected to render such support; cf. para. 1447. The European Commission’s State aid decisions sometimes do not contain more detailed information in that regard.

**Figure VI.3: Approved State aid (cumulated) by banking pillar from 1 October 2008 to 1 October 2012**



Source: own illustration. European Commission, [http://europa.eu/rapid/press-release\\_MEMO-14-126\\_en.htm](http://europa.eu/rapid/press-release_MEMO-14-126_en.htm), accessed on 7 May 2014.<sup>148</sup> The illustration contains all types of approved aid (incl. guarantees), irrespective of whether it was actually utilised.

**1449.** Upon request, the Federal Ministry of Finance has provided the Monopolies Commission with the average volume of the used measures of SoFFin and KfW/*Bund*, the *Bundesländer* and the relevant municipalities for the period from October 2008 to October 2012 and the still outstanding measures at the end of 2013. According to this information, the actually provided aid is lower than the originally approved aid, and it also diverges partially from the aid that is labelled above as “called upon” (para. 1445), which should be due particularly to different attributions of measures. According to it, the actually provided support per banking pillar amounts to the figures listed in the following **Table VI.2**.

**1450.** These illustrations confirm that the largest part of the approved and the actually provided support was rendered to institutions from the pillar of private banks. In the pillar of public banks, particularly the *Landesbanken* profited from State aid. From a competition policy perspective, also IKB could be counted among these institutions, 45.5% of whose shares were held by KfW (without this however having a large impact on the overall picture). The savings banks only used State aid to a minor extent and the cooperative banks not at all. Still, it is misleading if, based on the aggregated amount of aid granted, it is claimed that the private banks had the primary responsibility for the crisis whereas the public banks – except for the *Landesbanken* – and the cooperative banks had been the only ones to show responsibility and not to speculate (“gamble”) recklessly on the financial markets.

<sup>148</sup> Additionally, restructuring aid in the amount of EUR 3.3 billion and recapitalisation aid in the amount of EUR 2.6 billion was approved for Nord/LB in the relevant period. However, the European Commission accepted this aid primarily as needed recapitalisation within the context of the capital assessment conducted by the European Banking Authority (EBA), and it has consequently been left aside in the above chart; cf. European Commission, Decision of 25 July 2012, SA.34381 (2012/N), Germany (Restructuring aid to Norddeutsche Landesbank AöR).

**Table VI.2: Provided measures in the period from 1 October 2008 to 1 October 2012 (average volumes)**

<i>in billion EUR</i>	<i>Private banks</i>	<i>Landesbanken/savings banks</i>	<i>Cooperative banks</i>
Measures of SoFFin and KfW/Bund <sup>149</sup>	123 <sup>150</sup>	23.8	0
Other measures <sup>151</sup>	0	47.4	0
<b>Total</b>	<b>123</b>	<b>71.2</b>	<b>0</b>

Annotation: rounding differences are possible.

Source: own illustration; Federal Ministry of Finance

**1451.** The pillar of private banks is heterogeneous and is composed of individual institutions that compete with each other. In this pillar, the bulk of the State support was provided to HRE (approx. EUR 175 billion), which had assumed particularly high risk due to its business model based on extremely short-dated refinancing, and to Commerzbank (EUR 33.2 billion), which was forced to take recourse to substantial State aid not least because of the takeover of Dresdner Bank, which had been supported by the State (concerning Commerzbank, see also para. 1458).<sup>152</sup> The other large banks and also the majority of the smaller private banks did not call on public support.

**1452.** In contrast to the private banks, the savings bank group and the cooperative group form so-called associated groups (*Verbundgruppen*) that are organised based on work division and within which there is only limited competition. This group structure enables the savings bank group and the cooperative group to offer one-stop shop for all banking services, similar to the large banks. In the savings bank group, the central banks (DekaBank, *Landesbanken*) focus on corporate and investment banking, whereas the savings banks provide retail banking services to small corporate customers and private customers. In the cooperative group, a similar work division exists between DZ-Bank and WGZ-Bank on the one hand and the *Volks- und Raiffeisen* (VR) banks on the other hand. Since the savings banks and the cooperative banks were not responsible for anything like lending substitution activities within the group, it came as no surprise that they were barely affected by the financial crisis. Being the members of the savings bank group that were responsible for the corporate and investment banking, however, the *Landesbanken* to a great extent collapsed during the financial crisis and were forced to request substantial State aid, with only few exceptions. This aid was necessary despite the participation of the *Landesbanken* in the liability association scheme of the savings bank group.<sup>153</sup> The balance of the public banks in the financial crisis is sobering against this background. In the

<sup>149</sup> The measures (in billion EUR) for the private banks and the Landesbanken/savings banks can be broken down on the basis of the information available into guarantees (86.9 and 14.9), risk-shield measures (6.3 and 5.9) and capital measures (29.8 and 3.0).

<sup>150</sup> KfW share in IKB loans not included.

<sup>151</sup> The heterogeneity of the data sources makes aggregation difficult. Therefore, the quoted figures must be read as approximations. The measures (in billion EUR) for the Landesbanken/savings banks can again be broken down into guarantees (3.5 – until end 2013: 3.2), risk shield measures (27.0 – until end 2013: 28.2), and capital measures (16.9 – until end 2013: 17.1).

<sup>152</sup> European Commission, Decision of 18 July 2011, SA.28264 = C 15/2009 – Germany. State aid for the restructuring of Hypo Real Estate; Decision of 7 May 2009, N 244/2009, Germany. Capital injection into Commerzbank, supplemented in Case SA.34539, Germany. Amendment of restructuring plan of Commerzbank. As to Commerzbank, see critically already Monopolies Commission, Stellungnahme zum Finanzmarktstabilisierungsgesetz und dem “zweiten Konjunkturpaket”, press release of 22 January 2009. In that context, the guarantees for HRE amount to EUR 145 billion and the ones for Commerzbank to EUR 15 billion.

<sup>153</sup> The exceptions were for LBBW and WestLB; see European Commission, Decision of 15 December 2009, C 17/2009, Germany. Restructuring of Landesbank Baden-Württemberg; Decision of 20 December 2011, C 40/2009, Germany. Restructuring of WestLB; regarding this case, see Lienemeyer, M./Magnus, M., WestLB liquidation – the end of the saga, [2011] Competition Policy Newsletter No. 3, pp. 45-48. According to the authors, the case of WestLB is the only one so far where failed restructuring resulted in liquidation.

cooperative group, the central institutions likewise incurred critical losses during the crisis, but the group was able to compensate for the losses. Hence, the balance of the cooperative group in the crisis is better by far.

**1453.** It cannot be ruled out that the use of implicit guarantees has moreover given rise to so-called umbrella effects in the markets in which German institutions were active. For the use of an implicit State guarantee can distort competition not only to the benefit of the systemically relevant undertaking. Apart from that, also other financial market participants who do not themselves benefit from an implicit guarantee can benefit if the systemically relevant undertaking uses the guarantee protecting it. This is particularly likely in narrow markets with few suppliers, i.e., markets that are relatively lightly regulated and in which relatively large risk is concentrated.

It stands to reason that pricing without due account of the actual risk can result from the use of implicit guarantees in such markets, an aspect other suppliers can benefit from. The problem of umbrella effects is well known from cartel damage law. For cartel agreements can increase not only the pricing leeway of the cartel participants, but also the leeway enjoyed by competitors in the same market that are not part of the cartel.<sup>154</sup> In the context of the financial crisis, an example of umbrella effects resulting from the rescue of a systemically relevant bank may have to be seen in the development of mortgage loan prices in the Netherlands in the years from 2008 to 2010. In this case, the European Commission had conditioned the use of State aid by certain Dutch banks (among others, by so-called price leadership bans). This made the banks refrain from aggressive pricing advances on the Dutch mortgage market, which may have been anticipated by competitors and may have caused them to align their own pricing upward.<sup>155</sup> A similar development cannot be excluded for relevant markets in Germany.

**1454.** Further, the distortions of competition is not only reflected in the provided and used State aid, but they may even have had a market effect where institutions benefiting from such guarantees partially or completely abstained from calling on State aid (e.g., Deutsche Bank).<sup>156</sup> First, the relevant institutions benefited indirectly from the State aid provided to other banks and preventing the materialisation of the risk in the institutions' own books. Second, indications exist that new and in part substantial market distortions arose from the necessity for the relevant institutions to reduce quickly and to a large extent their risk and to therefore contract their balance sheets ("deleveraging").

**1455.** To a large extent, these distortions could not be felt in Germany because the institutions not affected by the crisis (especially, the savings banks and the cooperative banks) stabilised the system, meaning that a credit contraction following the international banks' deleveraging (due to the crisis and the tightened capital rules afterwards) could be avoided.<sup>157</sup> In addition, the more capital market oriented banks strengthened their capital in anticipation of the tightening of regulation due to the crisis, and they also improved their risk management (e.g. through credit limits). Thus, the German banks took steps of their own following the crisis in order to permanently stabilise the financial system in Germany.<sup>158</sup>

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<sup>154</sup> Cf. ECJ, Judgment of 5 June 2014, C-557/12, *Kone*, not yet officially reported, para. 34; detailed also *Beth/Pinter*, [2013] WuW 228.

<sup>155</sup> Cf. Schinkel, M.P., *State-aided Price Coordination in Dutch Mortgage Banking*, presentation, 2-4 September 2012 (EARIE); [http://acle.uva.nl/binaries/content/assets/subsites/amsterdam-center-for-law--economics/new\\_s/plbschinkelearie2012.pdf](http://acle.uva.nl/binaries/content/assets/subsites/amsterdam-center-for-law--economics/new_s/plbschinkelearie2012.pdf); accessed: 24 June 2014.

<sup>156</sup> Cf. Deutsche Bank, Annual Report 2008, p. 64; Annual Report 2009, p. 29.

<sup>157</sup> Cf. Council of Economic Experts, *Das deutsche Finanzsystem: Effizienz steigern – Stabilität erhöhen*, supra (fn. 9), para. 240. This applies at least to the extent that these institutions compensated the other banks' reduced loan provision. However, the demand for loans was equally limited, due to the economic downturn along with the crisis.

<sup>158</sup> In the future, the supervisory authorities will likely attend more to such measures taken by the market participants to improve their risk management; see FSB, *Principles for an Effective Risk Appetite*

**1456.** It is alleged, though, that the behaviour of the German banks that had backed the wrong investments on the US sub-prime market also contributed to the development of the European debt and economic crisis.<sup>159</sup> This is based on the finding that German and French investors – in particular, banks – had previously been the most important creditors of today’s crisis countries. Until 2008, international investors had been prepared to grant higher and higher loans to these countries and to buy their bonds. In the crisis – if they did not receive State aid support – they had to build up new capital and to contract their balance sheets to balance the losses generated through the investments in US mortgage securities. For this reason, they reduced their loans to domestic banks in the crisis countries at relatively short notice and shortened their bond positions, and they did this considerably before non-bank investors started to reduce their claims (before the Lehman collapse).<sup>160</sup>

Official data collections indicate that such a rapid decrease in claims (“sudden stop”) indeed took place (cf. **Figure VI.4**). The significance of the withdrawal of the German banks from the crisis countries remains to be assessed in detail. That being said, one would have to regard it as grave if the banks in any way contributed to the crisis there inasmuch as the currency and economic crisis has prolonged the effects of the financial crisis and has itself given rise to significant market distortions.

**1457.** The economic effects of the financial crisis in the longer term still can not be quantified completely. To date, the European Commission considers the effects on competition to be manageable.<sup>161</sup> However, overcoming the crisis by use of State aid and the rapid new regulation of the financial sector have brought about the following risks for competition:

- Corroboration or incomplete neutralisation of implicit guarantees and, consequently, furtherance of hazardous market behaviour outside the reach of the current regulatory measures (e.g., in the shadow banking sector),
- State-aid induced distortion of competition to the detriment of institutions not backed by the State (e.g., distortion of refinancing conditions),
- Burden on not systemically relevant (particularly, small) institutions through the current regulation intended to neutralise systemic relevance, and
- possibly further effects on the real economy.<sup>162</sup>

That these risks had to be accepted was to a large extent due to the existing circumstances, i.e., due to the complexity and urgency of the necessary measures, incomplete EU-wide supervision and coordination, and the principally justified hesitance of Member States regarding the use of financial support. Nevertheless, these risks can impair the development of competition on the financial and the real economy markets substantially long-term, and should therefore be monitored in the longer term.

Framework, 18 November 2013; FSB, Increasing the Intensity and Effectiveness of Supervision. Guidance on Supervisory Interaction with Financial Institutions on Risk Culture, Consultative Document, 18 November 2013. In Germany, rules on (anonymous) whistleblowers entered into force recently, which have increased the pressure to improve risk management; see § 25a(1)(6) No. 3 KWG.

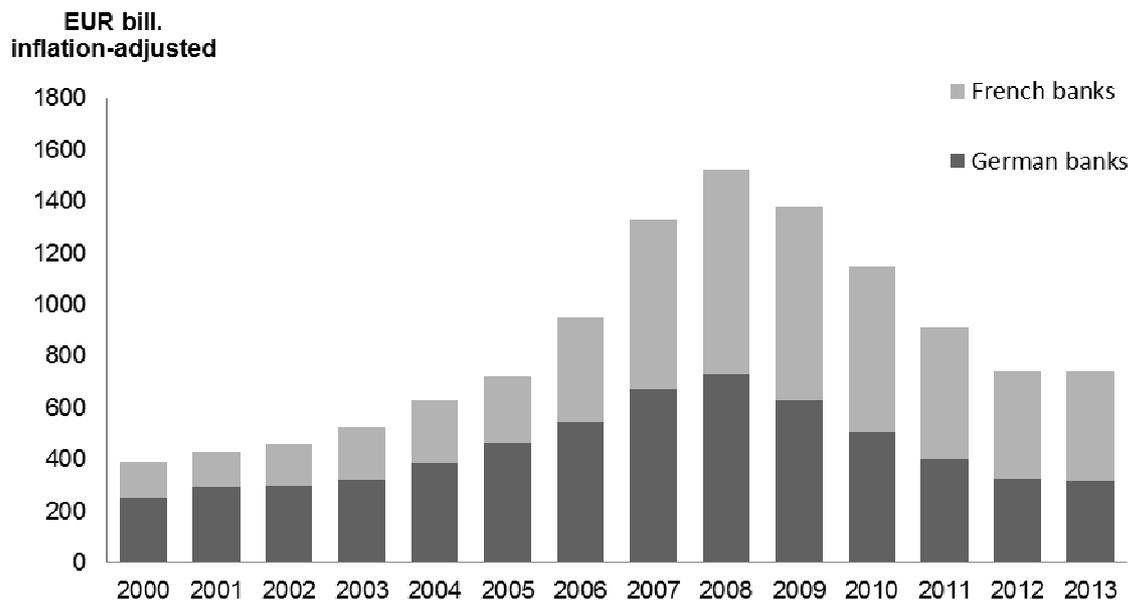
<sup>159</sup> Cf. Lindner, F., *supra*, however with conclusions on political recommendations that are not relevant in the context of this Report; WIFO (Austria), press release of 28 June 2013.

<sup>160</sup> See Council of Economic Experts, Annual Report 2013/2014, *Gegen eine rückwärtsgewandte Wirtschaftspolitik*, Wiesbaden 2013, paras. 359 ff.; European Commission, Economic review of the financial regulation agenda, Staff Working Document of 15 May 2014, SWD(2014) 158 final, pp. 39-40.

<sup>161</sup> European Commission, Report of 1 December 2011, State aid scoreboard. Report on State aid granted by EU Member States, COM(2011) 848 final, p. 5.

<sup>162</sup> See, e.g., European Parliament, State aid crisis rules for the financial sector and the real economy, study, June 2011, PE 464.427 (for the EU); Jeske/Krueger/Mitnam, Housing and the Macroeconomy: The Role of Bailout Guarantees for Government Sponsored Enterprises, NBER Working Paper No. 17537 (Oct. 2011) (for the US).

**Figure VI.4: Consolidated foreign claims by banks in Germany and France towards Greece, Ireland, Italy, Portugal, and Spain (cumulated)**



Source: own calculation. Quarterly data on foreign claims cf. Bank for International Settlements (BIS), consolidated statistics, 2014. Based on the quarterly data, yearly averages were calculated. For the conversion and inflation adjustment, a real effective conversion rate was used; cf. European Central Bank (ECB), Statistical Data Warehouse, 2014.

**1458.** In Germany, the competitive effects of the immediate State aid measures should be decreasing in the meantime. The banks receiving State aid have re-paid the received aid to some extent already, and have waived the benefit of most of the State guarantees.<sup>163</sup> Commerzbank seems to be a special case because it is profiting permanently from significant competitive advantages due to State aid according to competitor claims.<sup>164</sup> In the Monopolies Commission's view, it would be preferable that the State abolish this support in the entirety.

As concerns the reimbursement of the granted aid, the data communicated by the German Ministry of Finance provide the following picture (see Table VI.3):

<sup>163</sup> In that context, WestLB and HRE (and its legal successors) benefit from shifting "toxic" assets in resolution entities ("bad banks") controlled by the State.

<sup>164</sup> According to the Annual Report 2013, p. 21, the share of the *Bund* is still 17%; the SoFFin capital measures amounted to EUR 5.1 billion until 30 April 2013.

**Table VI.3: Provided measures – outstanding per 31 December 2013**

<b>Outstanding State aid measures in billion EUR</b>	<b>Private banks</b>	<b>Landesbanken/savings banks</b>	<b>Cooperative banks</b>
Measures by SoFFin and KfW/Bund <sup>165</sup>	23.4 <sup>166</sup>	2	0
Other measures <sup>167</sup>	0	54.2	0
<b>Total</b>	<b>23,4</b>	<b>56,2</b>	<b>0</b>

Annotation: rounding differences are possible.

Source: own illustration. Federal Ministry of Finance

However, giving back the aid granted during the crisis does not remedy the problem of implicit guarantees. The granted aid constituted a major interference with the market, as it distorts competition permanently in part. It delayed (WestLB) or even hindered market exits due to competition. Due to – frequently politically motivated – mergers, some of the larger institutions even grew in the course of the financial crisis.<sup>168</sup> This was to the benefit also of some institutions whose merger was not necessary to stabilise the system (e.g., in the case of Deutsche Bank/Postbank). On the other hand, still no appreciable consolidation has taken place, in particular where banks had problems in reaching a critical size and where consolidation consequently would be desirable with a view to increasing the efficiency of the financial sector to the benefit of the economy (e.g., among the *Landesbanken*).<sup>169</sup> Such consolidation not only meets political opposition, though, but it also meets legal obstacles (e.g., through the general-interest mandate of the public banks). The regulatory measures adopted so far are meant to neutralise the existing implicit guarantees, but it is still open to what extent they will be successful in doing so.

In addition, the cost associated with surmounting the crisis puts a serious strain on public finances and weakens parts of the German financial sector in a worrisome way.<sup>170</sup> The Sonderfonds Finanzmarktstabilisierung (SoFFin) established for bank recapitalisation generated a cumulated loss of almost EUR 21.5 billion from its creation in October 2008 to the end of 2013.<sup>171</sup> As a whole, a legacy of toxic assets amounting to EUR 637 billion was shifted into resolution entities and SPVs (“bad banks”), is reduced only very slowly, and puts a continuous strain on the banks and their owners.<sup>172</sup> It is concerning that substantial incentives currently exist for the banks given the low level of interest to invest again in business fields offering high yields and reflecting corresponding risk.

<sup>165</sup> The measures (in billion EUR) for the private banks and the Landesbanken/savings banks can be allocated based on the information available into guarantees (1.2 and 0.0), risk-shield measures (5.8 and 0.0), and capital measures (16.4 and 2.0).

<sup>166</sup> KfW share in IKB loans not included.

<sup>167</sup> The heterogeneity of the data sources makes aggregation difficult. Therefore, the quoted figures must be read as approximations. The measures (in billion EUR) for the Landesbanken/savings banks can again be broken down into guarantees (2.0), risk-shield measures (34.3) and capital measures (17.9).

<sup>168</sup> As to the merger proceedings, see FCO, Decisions of 14 November 2009 and of 18 February 2009, B4-133/08 and B4-29/09, Deutsche Bank/Deutsche Postbank; Decision of 10 December 2008, B4-134/08, Commerzbank/Dresdner Bank (/ Allianz SE); FCO, Activity Report 2007/2008, pp. 137-138; Activity Report 2009/2010, p. 57.

<sup>169</sup> In this context, higher concentration can also lead to higher stability; see the differentiating view of OECD, Competition, Concentration and Stability in the Banking Sector, Policy Roundtables 2010, particularly, pp. 21 ff.; recently also Bremus, [2013] DIW Wochenbericht Nos. 13+14, p. 3.

<sup>170</sup> The financial sector grew on the whole until 2012, which can be inferred from the credit institutions’ balance sheet total that had been at approx. EUR 7.19 trillion in 2006 and rose to a peak of EUR 8.93 trillion until May 2012 (+24%) before falling again to EUR 7,595 trillion until April 2014; cf. Deutsche Bundesbank, Bankenstatistik April 2013 and June 2014 (Tables I.1, Summe der Aktiva).

<sup>171</sup> FMSA, press release of 9 May 2014 on the year-end closing 2013 of the financial market stabilisation fund (SoFFin), the restructuring fund, and the Federal Agency for Financial Market Stabilisation (FMSA).

<sup>172</sup> According to the information available, a less burdensome solution is the forced capitalisation in the US; see Section 3.8.2. The quoted figures are based on Jones/Hübner (Reuters) “Geheimsache Bad Banks”, article of 14 April 2013; accessible: [www.format.at](http://www.format.at).

### 3.5.3 *The legal framework in EU State aid proceedings*

**1459.** As was mentioned in the previous section, the measures adopted by EU Member States to support individual institutions were subject to State aid review by the European Commission.<sup>173</sup>

**1460.** In this context, it became apparent soon that the existing standards for State aid assessments had to be modified given the systemic character of the crisis. The European Commission therefore developed a special legal regime by means of guidelines<sup>174</sup> and its decision practice – a legal regime that has been amended repeatedly in the meantime<sup>175</sup> – in order to bring in line the objectives of EU competition with the Member State interest to re-establish financial stability.

**1461.** In this legal framework, the Commission took account of the problem of implicit guarantees. As noted above, it distinguished between “fundamentally sound” institutions and institutions suffering from “endogenous difficulties” already at an early stage.<sup>176</sup> Later, it differentiated more in line with the risk profile in the individual case. In that way, the Commission considered that the business of some banks could no longer be financed under market conditions due to its risk. If a bank was fundamentally sound, it could be justified to a large extent in view of the objective of re-establishing undistorted competition to grant State aid to that bank, in order to save it from falling into distress due to the systemic disruptions.<sup>177</sup> In contrast, if a bank was “technically insolvent” due to its risk profile – i.e., irrespective of these disruptions – it was the European Commission’s view that it should in principle be liquidated.<sup>178</sup>

**1462.** In developing the State aid practice further, the European Commission also developed principles to counter the market problems induced by the crisis and the Member States’ rescue measures. The market problems due to the crisis included, in particular, the issue that the market was disrupted because of the systemic character of the crisis, and that the value of the assets of all banks had fallen considerably under the real market value because of the loss of confidence in the market. To prevent distortions of competition due to overly generous State aid grants, relief measures concerning the banks’ impaired assets were supposed to be limited to banks of (real) systemic relevance.<sup>179</sup> Regarding these banks as well, measures had to be taken to prevent the granted State aid from carrying forward implicit guarantees or even leading to new implicit guarantees.<sup>180</sup> It was equally necessary to counteract the fragmentation of the internal market.<sup>181</sup>

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<sup>173</sup> See Articles 107 ff. TFEU.

<sup>174</sup> Particularly the aforementioned Banking Communication (fn. 71), OJ 2008 C 270/8; the Recapitalisation Communication (fn. 66), OJ 2009 C 10/2; the Impaired Assets Communication (fn. 66), OJ 2009 C 72/1; the Restructuring Communication (fn. 66), OJ 2009 C 195/9; and the Communication on the application, from 1 January 2012, of State aid rules to support measures in favour of banks in the context of the financial crisis (Delimitation Communication), OJ 2011 C 356/7.

<sup>175</sup> Most recently, see European Commission, Communication on the application, from 1 August 2013, of State aid rules to support measures in favour of banks in the context of the financial crisis ([New] ‘Banking Communication’), OJ 2013 C 216/1. This Communication adapts the existing legal framework to the new banking regulation following the financial crisis. It is here only taken into account within the context of the regulation.

<sup>176</sup> Banking Communication, paras. 14, 33; Recapitalisation Communication, para. 12; more differentiated Impaired Assets Communication which only addresses the valuation of assets impaired through the crisis, but also there the risk profile is taken into account, para. 52; cf. also the references to *Moral Hazard* and expansion, e.g., in para. 36 of the Restructuring Communication.

<sup>177</sup> Restructuring Communication, para. 29.

<sup>178</sup> Impaired Assets Communication, paras. 22-23.

<sup>179</sup> Impaired Assets Communication, para. 12.

<sup>180</sup> Restructuring Communication, para. 28; Recapitalisation Communication, paras. 9-10, 18.

<sup>181</sup> Restructuring Communication, para. 29; Recapitalisation Communication para. 8.

**1463.** The objective of re-establishing homogeneous conditions for competition remained the starting point for assessing the State aid measures.<sup>182</sup> On this basis, the European Commission developed the following principles in its guidelines to balance the interest of protecting competition with the interests of financial market stability.

**1464.** Concerning the issue of the necessity of a particular State aid measure, the European Commission defined essentially the following principles as a basis:

- The financial crisis could result in value losses at all affected institutions (whether they were sound or unsound).<sup>183</sup>
- In view of financial stability, it had to be accepted that institutions were rescued in a relatively generous way, and that a trade-off was made in the short term with regard to the “burden-sharing” as to the crisis-related costs. In return, however, compensation at a later stage had to be foreseen, for instance, through claw-back clauses.<sup>184</sup>
- The State aid granted by the Member States must not increase the implicit guarantees further. In particular, it must not put competitors that received no aid at a disadvantage.<sup>185</sup> Therefore, restructuring aid, for instance, should only cover the costs to restore profitability, but it should not provide any possibility to expand in a way that would distort the market.<sup>186</sup>
- The relevant institution was asked to make a significant contribution before the provision of State aid. This means that the banks should use their own money to the largest extent possible to fund the restructuring measures. Losses should be covered by the available capital, and appropriate remuneration should be paid for State measures.<sup>187</sup> The lower the own contribution was which a bank provided during the crisis, the higher it had to be afterwards.<sup>188</sup>
- The State aid measures were subject to European Commission review with regard to their fundamental necessity to stabilise the financial market,<sup>189</sup> the necessity of the given amount of State aid, and regarding the characteristics of the affected markets<sup>190</sup>. With respect to the question whether the aid was appropriate, the risk profile of the banking business and the undervaluation of risk in the time before the crisis were taken into consideration.<sup>191</sup> With respect to the actual amount of the aid, proportionality had to be guaranteed: the market interference associated with the State aid measure had to be limited to a minimum and to take place in a non-discriminatory fashion.<sup>192</sup> With respect to the measures to limit the competition distortions due to the aid, the Commission verified that the competitive advantages to the benefit of the supported bank were not increased with regard to the size, scale and scope of its business activities.<sup>193</sup> Finally, procedural transparency should be provided for.<sup>194</sup>

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<sup>182</sup> Cf. Recapitalisation Communication, para. 11: “a level playing field and [...] a return to normal market conditions.”

<sup>183</sup> Impaired Assets Communication, further Restructuring Communication, para. 37.

<sup>184</sup> Restructuring Communication, para. 25.

<sup>185</sup> Restructuring Communication, para. 39.

<sup>186</sup> Restructuring Communication, paras. 22-23.

<sup>187</sup> Banking Communication, para. 25 ff.; Restructuring Communication, para. 24; Impaired Assets Communication, para. 21.

<sup>188</sup> Impaired Assets Communication, para. 25.

<sup>189</sup> Impaired Assets Communication, paras. 27-29; see also para. 32: State aid limited to toxic assets may not be sufficient.

<sup>190</sup> Restructuring Communication, para. 30.

<sup>191</sup> Recapitalisation Communication, paras. 13, 18, 22 ff. (i.e., also in this context, a distinction could be drawn between fundamentally sound and unsound banks).

<sup>192</sup> See also Banking Communication paras. 15, 35 ff.; Impaired Assets Communication, para. 16.

<sup>193</sup> Restructuring Communication para. 30.

<sup>194</sup> Impaired Assets Communication, paras. 20-21, 46; also regarding the issue which assets were impaired and

**1465.** Concerning the necessity for adequate compensation for the received State aid, the European Commission used an approach that it had developed for rescue and restructuring measures independently from the financial crisis.<sup>195</sup> On this basis, a distinction had generally to be drawn between compensation for the aid measure as such (remuneration at market value to the extent possible) and compensation for the associated distortion of competition. Distinguishing both elements remained difficult, though, which meant that only one single compensation was required in practice.<sup>196</sup> Nevertheless, the guidelines contain principles differentiating between the two forms of compensation to a certain extent:

- Compensation for the aid measure (remuneration):<sup>197</sup> The European Commission assumed – at least at the beginning – that recapitalisation posed no State aid issue if it was made at current market value.<sup>198</sup> It tolerated divergence from the market value only to a given extent, even in the case of sound banks.<sup>199</sup> Banks with endogenous risk (i.e., in practice, generally all institutions that were in distress during the crisis) in principle had to be liquidated or restructured.<sup>200</sup> The higher the compensation was for the State aid, the lower security provisions were considered to be necessary by the Commission regarding potential distortions of competition (including further compensation).<sup>201</sup>
- Compensation for distortions of competition: Regarding the competitive effects, compensation had to serve two farther-reaching objectives, causing the Commission to develop increasingly detailed guidelines in the course of time.

First, compensation had (also) to strengthen existing competition and to contribute to the internal market.<sup>202</sup> In the calculation of the compensation, losses in market value of the banks' assets were increasingly factored in, taking into account also the “intrinsic risk” of the banks.<sup>203</sup> The guidelines additionally contained individual provisions for a design of the State aid measure in line with competition (particularly, concerning claw-back mechanisms).<sup>204</sup> The profitability of the institution in the long term had to be considered as well.<sup>205</sup> Further, the measure was supposed to include incentives for the re-payment of the public capital.<sup>206</sup>

Second, the use of State aid to distort competition had to be prevented. The beneficiary bank therefore had to offer terms and conditions in line with competition, and was not allowed to use the State aid for expansion purposes.<sup>207</sup> Thus, its terms had to be in line with the existing situation on the financial market.<sup>208</sup> Moreover, it was necessary to take

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which were not. Participants to the procedure viewed particularly the transparency of the procedure as a problem.

<sup>195</sup> Cf. Impaired Assets Communication, para. 49, with reference to European Commission, Community Guidelines on State aid for rescuing and restructuring firms in difficulty, OJ EU C 244, 1 October 2004, p. 2.

<sup>196</sup> Cf. Impaired Assets Communication, paras. 50, 58.

<sup>197</sup> Cf. Delimitation Communication, paras. 5, 6 ff.; Recapitalisation Communication paras. 8, 19 ff.

<sup>198</sup> Cf. Recapitalisation Communication, para. 21.

<sup>199</sup> Cf. Recapitalisation Communication, paras. 25, 27; with additional details on the valuation: Impaired Assets Communication, paras. 39 ff.

<sup>200</sup> Cf. Recapitalisation Communication, para. 44.

<sup>201</sup> Cf. Recapitalisation Communication, para. 36.

<sup>202</sup> Cf. Restructuring Communication, para. 35; regarding the need for competition-related compensatory measures, cf. Impaired Assets Communication, paras. 58-59.

<sup>203</sup> Cf. Delimitation Communication, paras. 16-17. The term is not defined in the Communication.

<sup>204</sup> Cf. Restructuring Communication, para. 42.

<sup>205</sup> Cf. Delimitation Communication, para. 14.

<sup>206</sup> Cf. Recapitalisation Communication, para. 31.

<sup>207</sup> Cf. Restructuring Communication, paras. 43-44; Recapitalisation Communication, para. 37.

<sup>208</sup> Cf. Restructuring Communication, para. 45.

accompanying measures, for instance, to provide for the regular re-evaluation of the aid and for reporting obligations.<sup>209</sup>

Furthermore, other distortions of competition outside the directly relevant markets for the institutions had to be avoided, for example, on the markets of the buyers or creditors of the institutions.<sup>210</sup>

**1466.** Hence, the European Commission set a regulatory framework establishing for it significant leeway for market design.<sup>211</sup> In that context, it used the structure of rule and exception under Article 107(1) and (3) TFEU and the broad discretionary scope that it enjoys under European jurisprudence. A flexible approach was necessary already because certain problems became apparent only during the development of the crisis, such as the necessity to consider the “real” economic value of the bank assets where an adequate market price could no longer develop given the market failure due to the crisis.<sup>212</sup> In addition, the European Commission had to take account of the risk that banks were forced to leave the market without the notified State aid and that the market might then completely collapse under the circumstances.

**1467.** The procedure which was more based on negotiations than on legal criteria in its implementation, the lack of profundity of the competitive analysis, and the limited transparency of decisions were criticised repeatedly.<sup>213</sup> It was particularly criticised that the ordered structural compensatory measures interfered considerably with competition, but that they were partly made as a condition without it being apparent to what extent the relevant market problems were even related to the market position or behaviour of the State aid beneficiary. It was claimed that the compensatory measures also forced the State aid beneficiaries to focus much more on their domestic markets in the future, where some of them already enjoyed a relatively strong market position (risk of fragmenting the internal market).

**1468.** That said, this criticism did not call into question the entire regulatory framework that the European Commission had established to deal with the financial crisis, but it rather indicated that the State aid proceedings as such were not sufficient to completely “repair” the market.<sup>214</sup> The European Commission had to assess the notified support measures not only with regard to their competitive effects in the longer run, but it had to ensure primarily that the stability of the European financial system was restored and that farther-reaching damage to the European economy could be prevented.<sup>215</sup> Thus, the permanent restoration of a balanced relationship between competitive and stability-oriented regulation remains the task of politicians. The primary objective of competition policy must be to reduce the still existing distortions of competition due to crisis-related aid, and to minimise the necessity of future State aid to the extent possible. Still, the principles laid down in the Commission guidelines provide indications of which aspects have to be observed in that respect.

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<sup>209</sup> See, e.g., Banking Communication, paras. 13, 41; further, Banking Communication, para. 27: behavioural constraints.

<sup>210</sup> Cf. Banking Communication, paras. 48-49.

<sup>211</sup> Cf. also Recapitalisation Communication, paras. 3, 4-6.

<sup>212</sup> Cf. Impaired Assets Communication, paras. 15 ff., particularly paras. 32 ff., 37 ff. For this reason, the European Commission also assessed the notified aid in the later proceedings under Article 107(3)(b) TFEU and no longer under lit. c.

<sup>213</sup> See, e.g., Zimmer/Blaschczok, [2010] WuW, 142; Soltesz, [2010] WuW, 743.

<sup>214</sup> The decision practice indeed seems to be erratic or highly fragmented, cf. the illustration by Gual, J., [http://webcast.ec.europa.eu/eutv/portal/player/common/index\\_popup\\_slide.html?id=18627&slideSetId=18467&slideIdx=2](http://webcast.ec.europa.eu/eutv/portal/player/common/index_popup_slide.html?id=18627&slideSetId=18467&slideIdx=2); accessed: 24 June 2014.

<sup>215</sup> On the objective of financial market stability, cf. Articles 127(5), 114 TFEU, see also Art. 109(2) of the Basic Law. It would naturally have to be welcomed to remove the competitive distortions accepted in the State aid proceedings in their entirety; cf. para. 1386 and the previously mentioned Monopolies Commission press release on the takeover of Dresdner Bank by Commerzbank, fn. 152.

### ***3.6 Assessment of the more recent regulation – reduction of the distortions of competition?***

**1469.** To improve financial market regulation, various sorts of regulation are being discussed at the present time. The proposed measures are meant to neutralise implicit State guarantees (in particular, the structural measures) or to at least limit their development. Another group consists of measures facilitating the identification and better appraisal of risk (e.g., the introduction of a single European supervisory mechanism, changes in the rating system).

**1470.** From a competition policy perspective, the relevant measures must be assessed according to the extent to which they reduce the negative effects of implicit guarantees on other market participants, and whether they may distort competition themselves. Following the basic concept of the European Commission guidelines in response to the financial crisis, it must be ensured on both counts that the individual financial market participants assume responsibility for their hazardous behaviour as much as possible, and that they are not able to transfer the risk. Moreover, the relevant measures should not abet the (further) fragmentation of the European internal market.<sup>216</sup>

In its report, the Monopolies Commission chooses a conservative approach. It must be assumed that already small regulatory changes can have significant effects on the financial markets, and that these effects may also affect the real economy under the circumstances.

#### ***3.6.1 Neutralising the implicit guarantees at market exit***

**1471.** Since implicit guarantees keep systemically relevant banks in the market, the most effective means to reduce such guarantees of survival are mechanisms allowing or facilitating the market exit, or which provide for financing that makes the use of public funds superfluous. This includes on the one hand the planned resolution and divestiture rules (including the rules establishing a dual banking system), and on the other hand the provisions on bank recovery and on security mechanisms (institutional security and deposit insurance). In contrast, no measures of (State-financed) financial market stabilisation are relevant as it is exactly these measures that ought to be avoided.

##### ***3.6.1.1 Resolution and bank contributions***

**1472.** The special provisions on the resolution of banks supplement the general insolvency rules. They are meant to ensure that also systemically relevant banks can exit the market. The older view that banks “may” not become insolvent has turned out to be unsustainable from a macroeconomic perspective. In the most recent financial crisis the preferred solution was frequently not to break up banks, but – to the contrary – to merge them with each other, which has even increased the problem of implicit guarantees.

**1473.** In the following, the Monopolies Commission assesses the recently agreed European rules on the resolution of banks before it comments on the existing German provisions. In that context, it takes into account the FSB’s recommendations on bank resolution, which provide guidance on the current legislation in this area.<sup>217</sup>

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<sup>216</sup> Cf. New Banking Communication, paras. 7, 11/Banking Communication, para. 27; Restructuring Communication, para. 6; Impaired Assets Communication, para. 16. Such fragmentation would not only raise concerns from a competition policy perspective, but it would also directly run counter to the objective of increasing financial market stability as it would limit the options for risk adjustment between the financial market participants (“connectivity”).

<sup>217</sup> Cf. FSB, Key Attributes of Effective Resolution Regimes for Financial Institutions, October 2011.

*EU law*

**1474.** The European resolution rules stand in connection with the development of a European banking union, which is to be composed of a Single Supervisory Mechanism (SSM), a Single Resolution Mechanism (SRM), and a single financing mechanism.<sup>218</sup> The resolution rules consist of a number of laws and regulations that will harmonise the European rules also, to some extent, outside the SRM.<sup>219</sup>

The SRM is established through a Regulation for the resolution of credit institutions and certain investment firms (SRM Regulation) and an intergovernmental agreement of the Member States taking part in the SRM. The Regulation regulates the resolution procedure and the establishment of a single resolution funds and its national compartments, which will exist for a transitional period. The intergovernmental agreement regulates the transfer of national funds to the resolution funds and the mutualisation of the national compartments. The European Parliament adopted the Regulation on 15 April 2014, i.e., the version negotiated in the so-called trilogue.<sup>220</sup> It will probably enter into force shortly.

The Regulation is supplemented in substance and also geographically – for the Member States outside the SRM – by a Directive that harmonises the Member States’ resolution mechanisms at EU level, leaving the relevant supervisory competences outside the SRM on the Member State level (BRRD).<sup>221</sup>

**1475.** In addition, as a competition law measure, the European Commission has revised its State aid framework for bank rescue measures (New Banking Guidelines).<sup>222</sup> The European Commission will apply the New Banking Guidelines in accordance with the existing legislation. This shows that the use of the resolution rules is based not only on the provisions on the banking union, but also on European competition law (particularly, Article 107 TFEU).

**1476.** The Monopolies Commission does not comment on the issue of how the relevant mechanisms must be viewed as regards competences. This notwithstanding, it takes the same position as the Federal Government and the German Bundesbank, namely that the European treaties should be amended to the extent necessary to develop the SRM further.

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<sup>218</sup> The Single Supervisory Mechanism is meant to also further the harmonisation of the substantive prudential rules, particularly in the area of capital regulation. The creation of a European Financial Mechanism is controversial, particularly the future role of the ESM. For the details, see Council, Conclusions of 28 June 2013, EUCO 104/2/13 REV 2, para. 13; Opinion of Commissioner Barnier of 19 March 2013, MEMO/13/251; Council, press release No. 17131/12 on the 3205th Session of the Council on 4 December 2012, p. 7; and previously Council President Van Rompuy, H., press release of 26 June 2012 on the report: “Towards a genuine Economic and Monetary Union”, EUCO 120/12, p. 4; European Commission, press release of 12 September 2012, IP/12/953.

<sup>219</sup> These rules revert to earlier deliberations at EU level; see, e.g., The High-Level Group on financial supervision in the EU (de Larosière Group), Report of 25 February 2009, paras. 127 ff., 253 ff.; [http://ec.europa.eu/internal\\_market/finances/docs/de\\_larosiere\\_report\\_en.pdf](http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf); accessed: 24 June 2014; European Commission, Communications of 20 October 2009 and 20 October 2010, An EU framework for cross-border crisis management in the banking sector, COM(2009) 561 final and COM(2010) 579 final; Communication of 26 May 2010, COM(2010) 254 final.

<sup>220</sup> Regulation No. 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010, OJ L 225, 30 July 2014, p. 1 (“SRM Regulation”).

<sup>221</sup> Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council, OJ L 173, 12 June 2014, p. 190 (Bank Recovery and Resolution Directive, “BRRD”).

<sup>222</sup> European Commission, Communication on the application, from 1 August 2013, of State aid rules to support measures in favour of banks in the context of the financial crisis (“Banking Communication”), OJ C 216, 30 July 2013, p. 1 (see already above, fn. 175).

– *The content of the resolution rules* –

**1477.** The resolution rules of the SRM will in principle apply to all banks, with an exception only for groups that are not active across borders.<sup>223</sup> Behind this is the assumption that all banks are of at least potential systemic relevance. The resolution of banks not resolved within the SRM framework is provided for by the supplementing BRRD.<sup>224</sup> The provisions on bank resolution are aligned more with the general principles of company liquidation, as compared with the rules that applied in the crisis.<sup>225</sup> In principle, deviations will be possible in the future only where this is necessary in view of systemic risks. In contrast, the fundamental synchronisation of chances and the risk of liability or losses is meant to apply also to banks and the banks' creditors.<sup>226</sup>

**1478.** With regard to the allocation of competences, the question of who would adopt which measures within the framework of the SRM was controversial for a long time in the European legislative process. Pursuant to the final version of the Regulation, the ECB as the central European prudential authority, the European Commission as the EU executive and competition authority, the Council as the EU institution representing the Member States' interests, and a Single Resolution Board (the Board) will take part in such measures, the Board being composed of representatives of the participating EU institutions and the national resolution bodies as its permanent members.

**1479.** The resolution rules under the SRM Regulation are subordinated to regular bankruptcy law.<sup>227</sup> The resolution procedure will generally be available for all banks within the banking union, which are active as individual entities or which form part of a cross-border group.<sup>228</sup> In the decision of whether an institution should be resolved, account must be taken of whether and how the resolution objectives named in the Regulation can be achieved (the continuity of critical functions<sup>229</sup>, avoidance of significant adverse effects on financial stability, protection of public funds and of the depositors and investors that are exempt from liability).<sup>230</sup> In addition, there is the possibility of writing down or converting capital instruments.<sup>231</sup>

**1480.** The possibility of a resolution is to be ensured by a three-phased procedure, two phases of which will precede the resolution as preventive measures. The three phases can be labelled as follows: prevention, early intervention, resolution. The Member States are supposed to ensure that generally all banks prepare recovery plans.<sup>232</sup> In addition, the Board or the national resolution authority will have to prepare resolution plans, working together with the other competent national authorities, in order to assess the resolvability of the banks.<sup>233</sup> The Board or the resolution authority moreover will lay down minimum requirement for own funds and eligible liabilities in order to ensure that the relevant institution can be wound down and has a sufficient amount of convertible liabilities such that

<sup>223</sup> Article 7 SRM Regulation.

<sup>224</sup> In the following, the BRRD is referenced alongside to the extent that its provisions are relevant with regard to those cases.

<sup>225</sup> See also Article 15(1)(f) SRM Regulation, Article 34(1)(g) BRRD (alignment with creditor liability in bankruptcy proceedings).

<sup>226</sup> Cf. Schäuble, W. in: Löhe, Schäuble rechnet mit mehr Selbstanzeigen von Steuersündern, NOZ, 13 April 2013: "Each bank and each investor must know: chances are also risks." [*"Jede Bank und jeder Investor muss wissen: Chancen sind auch Risike."*]

<sup>227</sup> See, e.g., Recital 59 SRM Regulation.

<sup>228</sup> Article 7(2) in conjunction with Article 18(1) SRM Regulation.

<sup>229</sup> "Critical functions" means activities, services or operations the discontinuance of which is likely in one or more Member States, to lead to the disruption of services that are essential to the real economy or to disrupt financial stability due to the size, market share, external and internal interconnectedness, complexity or cross-border activities of an institution or group, with particular regard to the substitutability of those activities, services or operations (Article 2(1) No. 35 BRRD).

<sup>230</sup> Article 14(1), (2) SRM Regulation; Article 31(1), (2) BRRD.

<sup>231</sup> Article 21(1), (7) SRM Regulation.

<sup>232</sup> Articles 5 ff. BRRD.

<sup>233</sup> Articles 8-10 SRM Regulation; Articles 10 ff. BRRD.

resolution can be effectuated without threatening systemic stability.<sup>234</sup> Early intervention is meant to ensure that banks can restore their financial position even before they are failing or likely to fail.<sup>235</sup> Should resolution be necessary, a decision has to be adopted concerning the necessary measures. In that case, the necessary valuation of assets must be made in a prudent manner.<sup>236</sup>

**1481.** The resolution procedure of the SRM applies if (i) a bank is failing or likely to fail, (ii) there is no reasonable prospect that any alternative private sector or supervisory measures would prevent its failure within a reasonable time frame (e.g., loss absorption through an institutional protection system), and (iii) resolution action is necessary in the public interest (in particular, because of threats to systemic stability).<sup>237</sup>

The resolution procedure is initiated principally by the ECB, which informs the Board, the Commission, and the competent resolution authorities at the Member State level.<sup>238</sup> The Board then examines if a supervisory or private sector solution is possible under the circumstances. If this is not the case and resolution is necessary in the public interest, the Board develops a resolution scheme that includes information on the relevant resolution instruments and any request for backing by the bank resolution fund. Thereafter, the European Commission assesses the discretionary aspects of the resolution scheme adopted by the Board, and either approves or rejects the resolution scheme. Beside that, the European Commission can object to the exercise of discretion in the resolution scheme or, in certain circumstances, propose a diverging use of the resolution fund.<sup>239</sup>

Should the European Commission not determine that the resolution is necessary in the public interest, or should it modify the amount provided by the fund, the Council is asked to confirm the Commission's proposal. If the Council likewise does not consider the resolution to be in the public interest, the institution is generally liquidated pursuant to national bankruptcy law.

If the European Commission or the Council objects to the resolution scheme, the Board must modify the scheme accordingly. The Board's resolution decision generally enters into force within 24 hours. Any modifications due to objections must take place within eight hours. Afterwards, the resolution scheme is implemented by the national resolution authorities.

If the resolution involves a grant of State aid, the aid must be approved by the European Commission before the Board adopts the resolution plan.

**1482.** For the implementation of the resolution, there will generally be four structural resolution tools available. The first three resolution tools (sale of business tool, bridge institution tool, asset separation tool)<sup>240</sup> can be distinguished according to the type and the amount of the asset transfer to a new entity, whereas the fourth resolution tool ("bail-in" tool)<sup>241</sup> serves to recapitalise the bank by winding down and converting its liabilities. The resolution tools can be applied individually or together, the asset-separation tool however only together with other resolution tools.<sup>242</sup> In the event that only viable parts of the bank are transferred to a new entity, the remaining undertaking is liquidated in normal

<sup>234</sup> Article 12 SRM Regulation; Article 45 BRRD.

<sup>235</sup> Articles 27 ff. BRRD, also in conjunction with Article 13 SRM Regulation.

<sup>236</sup> Article 20(1), (6) SRM Regulation; Article 36(1), (5) BRRD.

<sup>237</sup> Article 18(1) Subsec. 1, and Article 16(1) Subsec. 2, Sections 5-7 SRM Regulation as to the conduct of proceedings.

<sup>238</sup> In the alternative, the Board can make this determination (in its executive session), three days after having made an unsuccessful request to the ECB.

<sup>239</sup> This includes the prevention or modifications of exemptions from the bail-in if these exemptions require the use of means of the fund or alternative financing mechanisms; Article 19(1), (3) SRM Regulation.

<sup>240</sup> Article 22(2), Articles 24-26 SRM Regulation; Articles 37(3), Articles 38-39, 40-41, 42 BRRD. The bridge institution tool is meant particularly for the carving out of "sound" parts of the undertaking ("good bank"), the asset separation tool for the carving out of "unsound" parts that are to be liquidated ("bad bank").

<sup>241</sup> Articles 22(2), 27 SRM Regulation; Articles 37(3), 43 ff. BRRD.

<sup>242</sup> Article 22(4) SRM Regulation; Article 37(4), (5) Subsec. 1 BRRD.

bankruptcy proceedings.<sup>243</sup> Moreover, the selection of the resolution tools depends on the given circumstances, i.e., taking into account also the available time.<sup>244</sup> Aside from the four resolution tools, accompanying measures can be adopted, for example, the management body and the senior management shall generally be replaced.<sup>245</sup>

**1483.** The costs of the resolution will be imposed on the equity investors (shareholders) and the outside investors (creditors) according to a “liability cascade” to the extent possible, following the rank order in insolvency proceedings.<sup>246</sup> To limit contagion risk, the Member States have to ensure from the outset that the competent authorities limit the amount of liability held by other institutions, which might be called upon for a bail-in.<sup>247</sup> Certain liabilities and deposits covered by the statutory deposit guarantee schemes are excepted from the liability cascade and spared. In this case, the deposit guarantee scheme assumes liability instead of the privileged depositors.<sup>248</sup>

**1484.** The funds collected by these means will be supplemented by a Single Resolution Fund within the SRM, and by national resolution financing arrangements outside it. The mechanisms will principally be funded through the banks’ *ex-ante* contributions and exceptionally also through *ex-post* contributions. Pursuant to the already existing provisions on the *ex-ante* contributions, generally all banks are supposed to pay a lump sum irrespective of their balance sheet total (“base contribution”), to which a risk-based extra amount may be added.<sup>249</sup> However, the individual design of the contributions to the resolution fund have not been determined yet.

**1485.** Taking into account the objectives of the resolution procedure, outside investors can in certain circumstances be excepted from liability, even if this makes necessary a limited further use of the resolution funds and alternative financing sources.<sup>250</sup> This is, however, only possible if the equity and outside investors contribute in the amount of at least 8% of the balance sheet total. In addition, the contribution of the resolution fund or the financing arrangement may principally not exceed 5% of balance sheet total.<sup>251</sup>

**1486.** The resolution funds in the SRM has a target funding level of EUR 55 billion, that is at least 1% of the covered deposits. The resolution fund will be created gradually, starting by forming “chambers” (compartments) out of the funds of the existing or to-be-established national restructuring funds. The funds of the chambers will be mutualised in the resolution fund over a period of eight years, starting with a 40% mutualisation in the first year. Liability will be transferred accordingly from the national funds to the Single Resolution Fund. Resolutions requiring the use of the Single Resolution Fund will in any case be coordinated at EU level.

**1487.** Other financing arrangements and alternative funding means are only meant to be used as a fall-back system (“backstop”).<sup>252</sup> The State is supposed to take over the resolution costs only as a last resort (including, through the ESM).<sup>253</sup>

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<sup>243</sup> Article 22(5) SRM Regulation (as to the sale of business and bridge institution tools); Article 37(6) BRRD (also: as to the asset separation tool).

<sup>244</sup> Article 22(3) SRM Regulation.

<sup>245</sup> Article 15(1) lit. c SRM Regulation, Article 34(1) lit. c BRRD. As to other measures, see Articles 35, 64 ff. BRRD.

<sup>246</sup> Articles 15(1), 17 SRM Regulation; Article 48 ff. in conjunction with Article 46(2) BRRD; see also New Banking Communication, paras. 40 ff., 66 (particularly, para. 44).

<sup>247</sup> Article 27(4) Subsec. 3 SRM Regulation; Article 44(2), last sentence, BRRD.

<sup>248</sup> Article 79 SRM Regulation; Article 109 BRRD.

<sup>249</sup> Cf. Article 70 SRM Regulation in conjunction with Article 103 BRRD.

<sup>250</sup> Article 27(5)-(10) SRM Regulation; Article 44(3)-(8) BRRD.

<sup>251</sup> Article 27(7) SRM Regulation; Article 44(5) BRRD.

<sup>252</sup> Articles 72-73 SRM Regulation; Articles 105-107 BRRD; see moreover Eurogroup, ESM direct bank recapitalisation instrument – Main features of the operational framework and way forward, Document of 20 June 2013, for capitalisations through the ESM.

**1488.** In order to align the resolution measures adopted in the SRM framework and State aid, the SRM Regulation provides that the competent national authorities will inform the Board if a bank needs extraordinary public financial support. Under the BRRD, in contrast, it has to be ensured that State aid measures will be notified to the European Commission.<sup>254</sup> On the Board's request, the Member States also must inform the European Commission without delay of any resolution measures potentially giving rise to State aid. To the extent that certain measures do not involve State aid, the Commission will examine the measures along the lines of Article 107 TFEU to ensure uniform competitive conditions across the internal market. This will apply at least in cases in which the resolution funds will be involved.<sup>255</sup> If the ESM is involved, a regular State aid assessment is probably warranted.

**1489.** The Commission has aligned its assessment criteria in the New Banking Communications to take account of the liability ranking order under the new resolution regime.<sup>256</sup>

– *Assessment of the resolution rules* –

**1490.** The harmonisation of the resolution rules for banks and the creation of the SRM within the framework of the banking union must be welcomed on principle as measures to reduce implicit guarantees.<sup>257</sup> These measures are an important step forward to reconcile the financial market participants' risk disposition and liability with each other, and to shift liability from the State (i.e., the taxpayer) back to the market participants after the crisis. The announcement of the liability cascade as such has already led to a reduction of the number of offshore constructs with an obscure risk profile, according to press reports.<sup>258</sup> Moreover, the establishment of the SRM can in the medium term result in rating markdowns, according to statements made by the rating agencies, which would reflect the reduction of the implicit State support for systemically relevant banks.<sup>259</sup> It is now important that the provisions on the creation of the SRM are implemented swiftly as the mechanism will constitute a central instrument for the neutralisation of implicit guarantees.

In the present context, the following principles are authoritative for the assessment of the individual resolution provisions:

- The resolution rules must cover all systemically relevant market participants and should not result in a flight of capital, also in the case of a crisis (“bank run”).

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<sup>253</sup> Cf. Articles 6(4), 8(6), (9) lit. i, 10(1), 14(2) lit. c, 18(4) lit. d and Subsec. 2, Article 20(6) and Recitals 41, 58, 100 SRM Regulation; Articles 5(3), 10(3), 7 lit. i, 15(1), 16(1), 31(2) lit. c, 36(5), 37(10), 56 and Recitals 31, 45, 55, 109 BRRD (unclear, however, Recital 41: “failing, [...] or when the institution requires extraordinary public financial support except in the particular circumstances laid down in this Directive”). Concerning direct bank recapitalisations through the ESM, see EU Council, press release of 27 June 2013, 11228/13; Eurogroup, ESM direct bank recapitalisation instrument – Main features of the operational framework and way forward, Document of 20 June 2013; and previously European Commission, Proposal of 12 September 2012 for a Council Regulation conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions, COM(2012) 511 final, p. 2 (bot.) and Recital 8. Restrictive also New Banking Communication, paras. 29, 40 ff., 58.

<sup>254</sup> Articles 18, 19(2) SRM Regulation; Article 56(1) BRRD in conjunction with Articles 107-108 TFEU.

<sup>255</sup> Article 19 SRM Regulation and further Recital 29.

<sup>256</sup> European Commission, New Banking Communication, paras. 40 ff., 66. The assessment criteria are generally tightened given the improved possibilities of resolution, cf. New Banking Communication, para. 29.

<sup>257</sup> Admittedly, readjustments will be necessary, e.g., concerning the interpretation of the criteria on when an institution is likely to fail; cf. ECB, Opinion of 29 November 2012 on the proposal for a directive, CON/2012/99, OJ C 39, 12 February 2013, p. 1. Thus, it is, e.g., assumed that the relevant savings banks would not have been able to survive the resolution of WestLB if the proposed rules had been in force.

<sup>258</sup> No author, Banken fahren Offshore-Konstrukte zurück, Der Standard, 15 July 2013 (for Austria).

<sup>259</sup> See, e.g., FitchRatings, Fitch Revises Outlook on 18 EU Commercial Banks to Negative on Weakening Support, press release of 26 March 2014. In that respect, it must be seen how things will develop.

- The market interference through coercive State measures must in all cases be limited to what is strictly necessary because the prudential authorities are in no better position than the banks themselves to make entrepreneurial decisions (also regarding decisions on the market exit).
- The rules on the financing of the market exit or recovery should, to the extent possible, confer planning security to the affected investors.

**1491.** The SRM creates a set of rules that generally apply to all banks in the euro area. Even beyond it, the Member States' resolution rules are harmonised by means of the BRRD. The scope of application of the SRM, which exceeds the one of the Single Supervisory Mechanism (SSM), prevents coordination problems with respect to the resolution of institutions that are active across borders. The resolution rules of the SRM are applicable to all banks and banking groups except for groups that are not cross-border, i.e., they are applicable always when recourse is to be taken to the resolution fund. These rules allow for the involvement of the national authorities in the resolution of non-cross-border groups, taking account of their specific market expertise, but they also imply a possibility of State aid outside the SRM.<sup>260</sup> It will depend on the implementation of the BRRD to what extent implicit guarantees will trigger Member State liability in such cases in the future.<sup>261</sup>

**1492.** The European resolution rules were in some cases criticised heavily in the course of the European legislative process. This criticism did not relate to their scope of application in most cases, but rather to the necessity and the credibility of the rules on the resolution procedure and the provisions on the liability of outside creditors and of the State. It was criticised that the resolution procedure under the SRM was designed in an excessively complicated way. It was also said that the bail-in instrument and the resolution funds would not guarantee sufficient outside creditor participation. In the light of experience, the State would pay in a financial crisis. Consequently, the resolution rules only created the illusion of a functioning resolution process. In the end, the taxpayer would still be liable.

**1493.** The final resolution rules take account of the voiced criticism in various important aspects. This holds in particular for the procedure in the context of the SRM. In the resolution process for systemically relevant banks, different interests must be counterbalanced. A balance must be struck between the objectives of financial stability and undistorted competition, and with the legitimate interests of the Member States. The significance of the resolution rules for the European financial markets generally militates for a process coordinated at EU level. At the same time, a clear allocation of responsibilities cannot be dispensed with in the procedure, given the significant burden that is associated with a bank resolution for the concerned entities.<sup>262</sup> In addition, parallel competences of regulators at EU and at Member State level should be avoided (mixing of competences).

The procedural rules of the SRM in their current version already take these aspects into consideration to a large extent.<sup>263</sup> The resolution procedure is primarily initiated by the ECB and primarily steered by the Board, where the competent resolution authorities are represented. This is appropriate since the decision on the resolution or restructuring of an institution and the associated procedural resolutions have a chiefly prudential nature and, thus, should be adopted by the prudential authorities – to the extent this is possible by law.<sup>264</sup> At the same time, it is thus ensured that the national authorities are involved in the resolution (which also implement the resolution themselves in entirely national cases).

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<sup>260</sup> Cf. Recitals 11, 22 SRM Regulation.

<sup>261</sup> See paras. 1523 ff. below concerning the situation in Germany. However, the competence of national authorities for the assessment of the public interest under EU law (Article 18(1) lit. c SRM Regulation) must be questioned.

<sup>262</sup> Cf. European Commission, C 9/2009, Restructuring of Dexia, where existing deficits became apparent.

<sup>263</sup> See FSB, Key Attributes of Effective Resolution Regimes, supra, p. 14, Section 8.

<sup>264</sup> Cf. Article 14(2) lit. a and b SRM Regulation.

Apart from that, the European Commission and the Council are closely involved in the process as well. In relation to the European Commission, this should be unavoidable as it has to protect competition in the context of the resolution procedure and must decide in State aid proceedings on support measures potentially distorting competition to the benefit of the affected institution (cf. Article 107 TFEU). Equally, the involvement of the Council should be unavoidable due to the potential risks to the national taxpayers, at least under the present conditions. That said, the Council's involvement must under no circumstances lead to a decision on bank resolutions that is based on political standards without respecting the framework of prudential and competition law.

Concerning the actual resolution process, it is expected that the Board will adopt conclusive decisions as a rule. The European Commission and the Council are involved in a secondary manner by way of opposition rights. In that way, also the risk of procedural delays can be kept relatively low. With the resolution being implemented only at the last stage, after the preparation of recovery and resolution plans and after early intervention, the three-phased procedure should generally allow for a relatively fast execution of the resolution.

**1494.** With regard to the procedural competences in the SRM, it would nevertheless be the preferable option to install an independent resolution body at the European level in the longer run, which would have broader legal competences than the Board and would generally decide centrally about resolution in all cases where the substantive conditions are met. That said, the present solution without clearly defined competences may be sufficient for a transitional period.

**1495.** It is striking the broad discretion left by the newly introduced rules of the SRM and the BRRD for the initiation of the resolution and the decision about the pertinent measures.<sup>265</sup> This discretion may be justified to take account of the situational conditions in which resolution and recovery decisions must be adopted, and thereby to leave sufficient flexibility to the competent authorities. The resolution tools provided for in the Regulation are the same as the instruments used to cope with the financial crisis in Europe and the United States and principally appear to be sensible. Particularly the explicit recognition of time constraints must be welcomed.<sup>266</sup>

**1496.** The market participants' participation in liability in the context of a bank resolution is now an established principle in the entire banking union. The liability of outside investors (bail-in) and the liability cascade are the core of the resolution rules. The introduction of such levelled liability can contribute significantly to ensuring an adequate burden-sharing and to increase the awareness in the market that high yield is tied to an equally high risk of loss, and that the latter must principally be borne by the investor itself.

**1497.** The creation of a resolution fund to cover the resolution cost in the SRM and of resolution financing arrangements in the Member States must be welcomed. The establishment of these financing mechanisms is generally modelled on the German approach (restructuring fund). That said, it was controversial for a long time in the legislative process whether only a Single Resolution Fund should be established for the banking union instead of national funds.

In that respect, it had to be considered on the one hand that the resolution fund planned in the SRM Regulation is itself not meant to be a security system, but that it is instead supposed to add to the existing security systems.<sup>267</sup> The fund is supposed to complement the liability of equity and outside

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<sup>265</sup> Cf. Hellwig in: Hellwig/Höfling/Zimmer, Gutachten E/F/G zum 68. Deutschen Juristentag, supra, p. E 53.

<sup>266</sup> See Articles 7(4) lit. a, 8(9) lit. d and i, 18(1) lit. b, 20(10), (11), (13), 21(3) lit. b, 22(3) lit. d SRM Regulation.

<sup>267</sup> European Commission, Communication from the Commission of 26 May 2010 to the European Parliament, the Council, the European Economic and Social Committee and the European Central Bank "Bank Resolution Funds", COM(2010) 254 final, p. 4. Concerning deposit insurance, in contrast, see paras. 1550 and 1555 below.

investors as a subordinate instrument in order to ensure the financing of resolution measures. In contrast, it is not supposed to protect the depositors. Consequently, the banks should not be able to take advantage of competition between national resolution financing arrangements. On the other hand, it had to be considered that the national financing mechanisms in the process of being established are financed through bank contributions. A pooling allowing banks to profit from the fund that have not paid in so far would entail competitive disadvantages for the banks that have paid in so far.

The Monopolies Commission therefore welcomes principally the establishment of a Single Resolution Fund in the context of the banking union. Nonetheless, it still supports the position of the Federal Government that resulted in the national financing arrangements being continued separately from one another for a transitional period, in particular until a political solution has been found for appropriate burden-sharing and until the potential necessity of amending the European Treaties has been clarified.

**1498.** Hence, the Monopolies Commission views the provisions on the financing of resolutions positively in principle. Nevertheless, it suggests developing the instruments provided for in the resolution rules further such that they take more account of competitive aspects.

**1499.** The liability participation of the market participants must be designed in such way that they are not treated unequally without justification in comparison to an insolvency (non-discrimination).<sup>268</sup> The rules on resolution financing heed this principle already by reducing the existing positive discrimination of market participants that hold an interest in an institution benefiting from an implicit guarantee. Such a positive discrimination is not fundamentally necessary for avoiding systemic threats because the individual creditor only faces an insolvency risk and not the risk of uncontrollable contagion effects that is associated with a systemic threat. Putting individual creditors in a better position in the context of resolution financing can therefore lead to a materialisation of possible implicit guarantees to these creditors' favour without this being justified in view of the objective of financial stability.

**1500.** However, equal treatment should also be pursued as an objective in that the liability, which the State so far assumed due to implicit guarantees, should not be shifted to other market participants who would not be required to contribute in the event of a company failure outside the financial sector. In a normal bankruptcy case, the business partners of the company in distress take over the risk of loss associated with the business relationship with that company. Accordingly, it must be made sure in the case of bank resolution that aside from the business partners, also the other market participants affected through contagion effects bear their share in the risk of loss to the utmost extent possible. With regard to the objective of financial market stability, exceptions from such a loss participation are considered to be necessary because regular bankruptcy proceedings are not possible due to the threat of panic reactions of the other market participants. These panic reactions, however, are primarily due to the market participants' uncertainty as to the viability of the institution and the associated risk of an unavoidable and potentially unjustified total loss. They do not, however, follow necessarily from the interest in avoiding a liability share at all. Therefore, it does not seem to be unacceptable from the outset to allocate a share of loss also to those market participants that were initially excepted partially or completely from paying a share for the rescue of the institution. Security systems and financing arrangements should take over a share in the losses permanently only to the extent that it is not possible to allocate a share in the liability for losses to individual market participants.

**1501.** The principle of equal treatment, as addressed immediately above, is basically also observed in the existing resolution structure, but with important exceptions. These exceptions may be due to the fact that the SRM is designed more to cope with a large single resolution case ("too big to fail") and less with several resolution cases of interconnected banks in parallel ("too connected to fail") or banks

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<sup>268</sup> Cf. Recitals 59, 63, 65, 77 of the SRM Regulation.

with parallel business models (“too many to fail”). That said, the exceptions have as their result that liability risks can be passed on to other market participants permanently without clear justification, or that the State itself assumes the risks again.

**1502.** This can be observed first in the context of the rules of outside creditor liability. It must be expected that only few bank creditors will be affected by outside creditor liability since, according to the responsible Commissioner’s estimate, the deposit guarantee schemes will assume liability for 95% of the creditors, which means conversely that the liability exception for covered deposits (up to EUR 100,000) will apply.<sup>269</sup> Transferring the liability of small depositors to the deposit guarantee schemes in principle does not provoke objections on competition grounds. It takes account of the fact that the statutory deposit guarantee system was actually established as an insurance for small depositors against the distress of their bank. Moreover, the depositors are generally barely in a position to assess the risk of their bank and to protect themselves. In this context, however, it must be left open whether the adopted rule to the benefit of small depositors will be sufficient to prevent panic withdrawals in a crisis scenario (bank run). In any event, though, it must be made sure that the deposit guarantee systems are designed in such way that they can cope with the distress of multiple institutions in the context of a systemic crisis (e.g., due to parallel business models – too many to fail).<sup>270</sup>

**1503.** The contribution of the other liable creditors is all the more important given the privilege for covered deposits. For these creditors, it is more important than for small depositors that they enforce a risk-adequate investment policy at the relevant bank because the bank’s default with contagion effects hitting these creditors also entails higher systemic risk (in particular in cases of high interconnectedness – too connected to fail).

**1504.** A particular problem of outside creditor liability is the interconnectedness of banks due to credit liabilities (interbank loans). Such interconnectedness can put significant obstacles in the way of the wind-down even of individual banks as it facilitates contagion effects. For this reason, the European rules provide for the first time that the Board or the competent authorities in the Member States restrict the amount of liabilities suited for bail-in, which are held by other banks.<sup>271</sup> These provisions heed a claim that was previously made at the EU level and in Germany.<sup>272</sup> They must be welcomed although they do not address indirect connections and consequently will probably be capable of reducing existing contagion risks only to a limited extent.

**1505.** Incidentally, however, the provisions on the liability cascade leave rather many options for exceptions. The European Parliament’s position in the legislative process was much more restrictive, but does not appear to have had an impact on the final text.<sup>273</sup> Regarding the potential exceptions, the following applies:

- The exceptions for creditors protected under insolvency law must generally be accepted. The exceptions for secured liabilities should also be justifiable as a loss of confidence in the collateral should be avoided. This applies at least to the extent that the collateral would

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<sup>269</sup> Commissioner Barnier, as quoted in: no author, EU und Deutschland bei Bankenabwicklung auf Kollisionskurs, Stuttgarter Zeitung, 13 April 2013.

<sup>270</sup> See also para. 1552 below.

<sup>271</sup> Article 27(4) Subsec. 3 SRM Regulation; Article 44(2), last sentence, BRRD. These provisions are complemented by the exposure limits recently proposed by the Basel Committee; see paras. 1601 f. below.

<sup>272</sup> High-level Expert Group on reforming the structure of the EU banking sector (chair: Erkki Liikanen), Final Report, 2 October 2012, p. 104; recently also Scientific Advisory Council at the Federal Ministry of Finance, Stellungnahme zur aktuellen Entwicklung der Europäischen Bankenunion-Plädoyer für ein glaubwürdiges Bail-in, January 2014.

<sup>273</sup> Article 24 Abs. 5 SRM Regulation in the version of the motion for a resolution of the rapporteur, A7-0196/2013.

provide the right to demand separate satisfaction in the event of bankruptcy.<sup>274</sup>

- In contrast, it does not seem necessary by implication that short-dated liabilities or liabilities to certain creditors (e.g., employees, suppliers, public agencies) are excepted from liability, and that is without the possibility of later regress and in so far as no corresponding exceptions should exist under insolvency law.
- It must be criticised that the option provided in the original Commission proposal to make exceptions from creditor liability in individual cases has largely been kept.<sup>275</sup> The preconditions for justifying an exception (“in exceptional circumstances”) will arguably be met by implication at least as regards any larger banks in a systemic crisis. In so far as the State reserves discretion, liability is also not necessarily shifted to the depositors and investors.

**1506.** A factor that must be welcomed is the outside creditors’ minimum liability before recourse is available to the resolution funds or the financing arrangements in the Member States. The determination of an express threshold value, however, can be misinterpreted and induce preferred treatment as compared to insolvency proceedings in which no such threshold applies. At least, it should be made sure that recourse to existing outside capital should take place always beyond this threshold where individual creditors cannot prove why they should enjoy preferred liability treatment as compared with other creditors. To allow for *ex-post* liability at least, exceptions from the bail-in tool should be conditioned or limited in time.<sup>276</sup> It does not seem unacceptable to provide for such recourse at least under national law.<sup>277</sup>

**1507.** The resolution fund and the financing arrangements in the Member States are liable in subordinate ranking order if no resolution is possible even if the existing security systems and the equity and the outside investors are called upon.

**1508.** The target funding level of the European resolution funds is with EUR 55 billion lower than that of the German restructuring funds (EUR 70 billion). That target funding level is criticised as being too low. To counter this criticism, it is said that capital regulation requires a bolstering of capital buffers and that the resolution is primarily expected to be funded by the equity and outside investors. Apart from that, it is necessary to take into account that the resolution funds is not meant to finance recoveries, which rules out any comparison with the sums expended in the financial crisis for bank rescue measures.

Nevertheless, the criticism of the target funding level must be taken seriously. If a large bank must be resolved and the liable capital of equity and outside investors does not suffice, it appears plausible already given the business volume of such institutions that the resolution funds would reach their limits relatively quickly.<sup>278</sup> In the event of another systemic crisis, a large number of medium-sized and large banks could again risk defaulting. In addition, it must be considered that the resolution funds are supposed to help to dissolve the connection between the budgetary situation of individual Member States and the financing cost of the banks that are active there.<sup>279</sup> These connections increase

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<sup>274</sup> See also Article 27(4) SRM Regulation and Article 44(2) Subsec. 4 BRRD regarding the power of the resolution authorities to apply the bail-in tool by individual decision.

<sup>275</sup> Cf. Article 27(5) SRM Regulation; partly broader Article 24(5) of the Proposal of 10 July 2013 for a Regulation establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Bank Resolution Fund, COM(2013) 520 final.

<sup>276</sup> Cf. Article 27(5) SRM Regulation (“or partially”).

<sup>277</sup> Cf. Article 73 SRM Regulation.

<sup>278</sup> For instance, the major German banks Deutsche Bank (EUR 2.01 trillion), Commerzbank (EUR 635 billion) oder Unicredit (HVB) (EUR 348 billion) each have a balance sheet total exceeding the target level by far.

<sup>279</sup> Recital 19 of the SRM Regulation.

the probability that national political interests will co-determine bank resolutions.<sup>280</sup> In any case, however, it must be avoided that the market participants call into question the credibility of the SRM as this could jeopardise seriously the reduction of implicit guarantees.

In the Monopolies Commission's understanding, it is still unclear which role the resolution funds will in fact play in future bank resolution scenarios. At this stage, it considers it to be most pressing to ensure the accumulation of sufficient funds in the prescribed time frame. Depending on the significance of the fund for the SRM, however, an increase of the target funding level should be considered in the future.

**1509.** On the other hand, the Monopolies Commission takes the view that the contributions to the resolution fund cannot be considered to replace adequate capital requirements. It is generally preferable to capture systemic risk through regulatory capital requirements, as is provided for by the extra amounts foreseen for systemically relevant banks in the implementation of Basel III. The creation of a resolution fund with corresponding obligations to contribute should therefore only rank second in the combat of systemic risk.

**1510.** In view of the objective of competition policy to attribute liability to the investors in the defaulting or near-to-default bank and the other market participants affected by contagion effects, it should be made sure that the resolution fund and the financing arrangements in the Member States are designed in a way allowing for an acceptable burden-sharing, and that, in any liability scenario, they take over risks of loss only to a truly indispensable degree.

**1511.** Regarding the design of the resolution fund and the financing arrangements in the Member States, the rules on *ex-ante* contributions principally allow for adequate burden sharing, but it is still necessary to wait for the final design. In that context, the fact that all banks pay a (low) lump sum contribution does not raise concerns from a competition policy perspective since the use of the SRM will benefit all banks in the event of a systemic threat. However, the institutional security mechanisms existing in Germany should be taken into account when the contributions are set because these mechanisms are another element contributing to the stabilisation of the system.<sup>281</sup> In contrast, the risk-based extra payments should be made only by institutions that are likely to be resolved in the framework of the SRM. It must be welcomed that account will be taken of the banks' risk profile with regard to these extra payments. The payment criteria will reflect the systemic relevance of the contributory institutions and can be an element that at least partially internalises the advantage resulting from the implicit guarantee for systemically relevant institutions. Nevertheless, it is crucial that the risk-based contributions will not be too low as they will otherwise not be able to have a significant regulatory effect.

**1512.** As a rule, the use of the resolution fund and the financing arrangements in Member States will be subject to strict conditions.<sup>282</sup> This implies that the use of the fund – like all other measures for bank resolution in the EU – will also be assessed as regards its compatibility with the rules on State aid and the internal market.<sup>283</sup> Such an assessment will take into account that the fund will only be available for resolutions taking place within the SRM due to an existing public interest. Moreover, there will be a possibility that the fund will use public financing tools.<sup>284</sup> From a competition policy

<sup>280</sup> According to a European Banking Authority (EBA) survey of 20 December 2013, EU banks frequently hold more than 60% and sometimes more than 80% of the sovereign bonds of their domestic State in their books (Germany: 72%); see EBA, EU-wide Transparency Exercise 2013, Summary Report of 16 December 2013, p. 13. The investments of the fund will probably prolong the connections between banks and Member States; cf. Article 75(3) SRM Regulation.

<sup>281</sup> Cf. Demary, M./Schuster, T., *Die Neuordnung der Finanzmärkte. Stand der Finanzmarktregulierung fünf Jahre nach der Lehman-Pleite*, supra, p. 105.

<sup>282</sup> Cf. Article 76 SRM Regulation and the provisions concerning the intended purposes specified in that Article.

<sup>283</sup> Recitals 29, 30 and Article 19 SRM Regulation.

<sup>284</sup> Article 74 SRM Regulation.

perspective, the use of the resolution fund is in that context comparable to State support measures or will be connected to such measures.<sup>285</sup> The assessment in accordance with State aid principles will ensure that the resolution fund and the financing arrangements in the Member States are normally only used if the equity and outside investors assume a fair share of liability.

**1513.** After the resolution fund has provided financing and the crisis situation has been averted, it would nonetheless be desirable if the fund could take recourse at the investors whose capital the relevant bank has used for the investments due to which it is in distress.

That recourse has not been foreseen yet, which may be understandable given the insurance-like character of the resolution fund. The resolution fund is liable for the risk of loss associated with the bank's default if the equity and outside investors do not assume that risk in the first place. Different from an insurance, however, the contributions to the resolution fund are calculated not based on the risk of the capital investors that are discharged of their liability, but based only on the risk of the bank. Consequently, it is not the investors who must answer for the remaining risk, but the banks remaining on the market, *i.e.*, the competitors (particularly, for the systemic risk).<sup>286</sup> Admittedly, it is possible to collect *ex-post* contributions when needed. These contributions are, however, collected from all other institutions as well. Thus, other market participants are required to pay for the default than those that originally have profited from having business with the distressed institution through their deposits and investments. Taking recourse could correct this liability shift.

Moreover, there is a possible risk of pro-cyclical developments if banks have to make *ex-post* contributions while the crisis is still raging. In contrast, the risk of contagion effects would not necessarily increase if it were possible to take recourse at the equity and outside investors of the bank in distress.

**1514.** Apart from that, it must be welcomed that the rights of the equity and outside investors have been strengthened vis-à-vis the original proposal for the Regulation. The legal rights now foreseen protect the capital investors against disproportional interference with their rights.<sup>287</sup> In addition, however, it would be desirable that also the protection of the rights of the market participants be strengthened, who suffer competitive or other disadvantages in the context of measures adopted under the resolution rules. For example, competitors of the rescued institution should be allowed to lodge an *ex-post* action against the rescue measures in particular if they can prove that reasonable doubt existed about the public interest in the State rescue measures, and that the competitors would have covered the demand of the saved institution. That protection of rights would necessarily be difficult to achieve, but it would increase the legitimacy of the SRM and prevent the political abuse of existing leeway.

**1515.** The possibility to use Member State funds in the individual case and the ESM – as a last fall-back position (“backstop”) – prolongs the existing implicit guarantees. Given the still low capitalisation of most banks, it may still be illusory that it will be possible to save globally systemically relevant banks, in particular, without a bail-out in the future.<sup>288</sup> This is all the less likely taking into consideration that the assets controlled by banks in the euro area make up approximately 270% of GDP, and that particularly the large banks are leveraged to a degree that gives rise to concerns.<sup>289</sup> The use of public funds must nonetheless be limited to a minimum. In every case where

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<sup>285</sup> In that context, it will also be necessary to treat equally banks within the banking union and banks outside the banking union the resolution of which must be financed through national financing arrangements.

<sup>286</sup> The problem would continue to exist if the primary institutions of the German associated groups (savings banks, VR banks) were exempted from paying the planned lump sum contribution.

<sup>287</sup> Cf. Article 20 and Recitals 61-63 of the SRM Regulation; Articles 21, 36, 50, 73 ff. BRRD.

<sup>288</sup> Cf. paras. 1561 f., 1591.

<sup>289</sup> Cf. ECB, Banking Structures Report, November 2013, p. 30 (figures of the end of 2012); Advisory Scientific Committee at the ESRB, *Is Europe Overbanked?*, supra, pp. 8-9; for more details on the composition of the assets and the risks associated with the “loan-to-asset ratio”, see also supra, pp. 29 ff.

a bank is restructured or resolved with public money, it must moreover be the rule that the beneficiary bank or its capital investors have to pay back all subsidies completely.<sup>290</sup> It is hardly reconcilable with these principles that the resolution rules and the agreement on direct bank recapitalisations through the ESM only contain vague principles that leave much discretion to the Member States to finance resolution measures for political reasons with taxpayer money. It must be feared that bail-ins and bail-outs can be applied alternatively also in the future. This leaves accordingly leeway to the investors to build on State measures in their planning.

**1516.** In the context of the ongoing balance sheet assessment and stress tests before the start of the SSM, it has been discussed under which conditions banks in distress can receive State aid in the context of the stress test, regardless of the conditions imposed through the new resolution rules. The Monopolies Commission opposes such aid as a matter of principle as otherwise, there would be a risk that such aid is used to circumvent the resolution rules. In that respect, the Monopolies Commission supports the critical position adopted by the European Commission and the Federal Government.

**1517.** In conclusion, it remains to be seen how the European resolution rules will play out in practice. An indication of the potential effectiveness may be derived from rating agency announcements that the ratings of banks that so far benefited from rating advantages due to implicit guarantees could deteriorate as a consequence of the regulation. Such a deterioration would generally have to be accepted as it reflects the shift of risk to the private creditors. Moreover, it must be assumed that the new liquidity requirements and the resolution authorities' power to extend liability also to secured investments may constitute features that can counteract the banks' tendency to redeploy capital into (more expensive) secured investments and to shorten the duration of the investments, in order to prevent the liability of outside capital.<sup>291</sup>

Nonetheless, some scepticism is warranted. The resolution rules do not take account of competition concerns in every respect so far. Experience moreover shows that bank resolutions mandated by competition principles are avoided for political reasons during a crisis. To that end, also existing statutory requirements are interpreted in a downright political manner. Following the last crisis, some banks, also in the German-language area, continue to exist that remain on the market only due to massive State subsidies and that consequently continue to hold the State liable. Nor does there appear any willingness so far as to a possible resolution of these banks. The resolution rules cannot be expected to have any impact in that regard either.

### *German law*

**1518.** In Germany, several statutes were passed during the crisis in order to facilitate bank resolution and recovery.<sup>292</sup> The Law on the reorganisation of credit institutions (Gesetz zur Reorganisation von Kreditinstituten – KredReorgG) contains general provisions providing a (voluntary) recovery procedure as an alternative instead of bankruptcy proceedings to banks. In addition, that statute and the Banking Act (Kreditwesengesetz – KWG) include special rules on the reorganisation of credit institutions whose distress poses a threat to systemic stability. In that regard, the rules in the Banking

<sup>290</sup> ECB President Draghi, as quoted in: Jost, Banken wollen Klarheit über den Stresstest, Die Welt, 25 November 2013; already previously FSB, Key Attributes of Effective Resolution Regimes, supra, p. 12, Section 6.2.

<sup>291</sup> Cf. Article 27(4) SRM Regulation; similarly Article 44(2) Subsec. 3 BRRD; further Articles 411 ff., 510 of Regulation 575/2013. For asset transfers before State aid proceedings, see also New Banking Communication, paras. 47 ff.

<sup>292</sup> See, particularly, §§ 47a ff., 48a ff. KWG and §§ 1 ff. KredReorgG, set in force by Gesetz zur Restrukturierung und geordneten Abwicklung von Kreditinstituten, zur Errichtung eines Restrukturierungsfonds für Kreditinstitute und zur Verlängerung der Verjährungsfrist der aktienrechtlichen Organhaftung (Restrukturierungsgesetz), BGBl. I 2010 No. 63, pp. 1900 ff., an the Gesetz zur Abschirmung von Risiken und zur Planung der Sanierung und Abwicklung von Kreditinstituten und Finanzgruppen, BGBl. I 2013 No. 47, p. 3090.

Act (§ 48a ff. KWG) relate to measures ordered by the prudential regulator. In addition, the Banking Act includes provisions (§§ 47 ff. KWG) concerning the preventive recovery and resolution planning of credit institutions and financial groups that may pose a systemic threat to financial stability (“living wills”). To execute recovery and reorganisation measures requiring financing that is not available on the market, a restructuring fund exists the objectives of which are laid down in the Law on the Restructuring Fund (Restrukturierungsfondsgesetz – RStruktFG).

These rules must finally be seen in the context of the legislation on financial market stabilisation, which remains in force alongside and constitutes a national back-stop framework – outside the actual resolution rules – (comparable, in that regard, to the ESM).

– *The content of the resolution rules* –

**1519.** The German rules in force consist of general rules for all banks and special rules for systemically relevant institutions. The powers to order mandatory reorganisation measures follow from the concept of a “systemic threat”.<sup>293</sup> Consequently, the conditions for imposing resolution measures are framed broadly also under German law.

**1520.** The structural instruments in a reorganisation case are dispersed over the relevant statutes, but they equal more or less the tools at EU level in substance. The asset separation tool<sup>294</sup> is notable in that regard. Asset separation can be effected through an asset transfer to an existing or newly created entity (e.g., a bridge bank).<sup>295</sup> A partial transfer is possible as well.<sup>296</sup> Aside from that, the tools of the legislation on financial market stabilisation continue to be available, in particular, the transfer of risk positions to an SIV created by the bank itself, or to a resolution institution created under federal law or the law of the *Länder* (bad bank).<sup>297</sup> Bank expropriation was legally possible beyond these rules at least temporarily during the crisis.<sup>298</sup>

These structural tools are complements by multiple accompanying powers that are partially spelled out in general prudential regulation and that allow, for example, interference with creditor rights<sup>299</sup> and the forced termination of contracts<sup>300</sup>.

**1521.** In principle, the transferring undertakings must always make financial contributions by paying compensation for the taking over of risk positions and State guarantees.<sup>301</sup> Under the existing rules, for example, in particular the transfer to a bridge bank results in creditor participation in the loss (bail-in). In addition, a bank can voluntarily foresee the conversion of claims into equity in its reorganisation plan.<sup>302</sup> Just like at EU level, however, potential compensation for loss of rights is provided for also under German law. In case the financial market stabilisation appears to require the use of additional funds, a restructuring fund was created as well, which means that a liability cascade also exists in German law.<sup>303</sup>

<sup>293</sup> Cf. § 48b(2) KWG.

<sup>294</sup> § 11 KredReorgG.

<sup>295</sup> § 11(2), (3) KredReorgG, § 48a KWG, § 5 RStruktFG.

<sup>296</sup> § 48k KWG.

<sup>297</sup> §§ 6a, 8a-8b FMStFG.

<sup>298</sup> § 1 RettungsG.

<sup>299</sup> § 12 KredReorgG. In addition, interferences with the management of the bank are also possible under German law, see, e.g., § 45c KWG.

<sup>300</sup> § 13 KredReorgG in conjunction with the regular termination and unwinding rules.

<sup>301</sup> §§ 48d(1)(3), 48d(6) KWG; § 11(1)(3) KredReorgG; §§ 2, 12 RStruktFG; §§ 6b, 8a(4), (7), § 8b(1) No. 3 FMStFG.

<sup>302</sup> §§ 9, 12 KreditReorgG

<sup>303</sup> §§ 1, 4(1) RStruktFG.

**1522.** The use of public funds is generally only a fall-back option. To the extent that the different tools existed already in the financial crisis, however, the experience with their application suggests that the use of public funds depends more on political decisions than on legal conditions.

– *Assessment of the resolution rules* –

**1523.** It may be expected that the existing German resolution rules will barely be applied in practice. For the purposes of this Report, it is assumed that the Single Resolution Mechanism can be put in place before a new acute crisis arises. A draft for the implementation of the BRRD has been presented already.<sup>304</sup>

**1524.** The existing German rules must, in principle, already be seen positively. They contain principles that are more or less comparable to the European resolution rules, and they set a not insignificant example for the latter rules – apart from others (e.g., British law) – given that they were in force earlier already. Different from the current European resolution rules, German law also provides explicitly – as mentioned above – for adequate compensation for the State aid rendered to a bank during a crisis. The risk for the taxpayers should have diminished considerably since these rules were put in place.

**1525.** Following the establishment of the banking union, it must be assumed that the German rules can be adapted relatively easily to the EU's BRRD, to the extent that this is necessary. The Monopolies Commission would nonetheless welcome it if the German Legislature not only made individual amendments to the law, but fundamentally revised the Banking Act, systematically restructuring it and incorporating the provisions dispersed throughout accompanying statutes (KredReorgG, FMStFG, etc.). Due to multiple amendments and additions in recent years, the provisions are confusing – for non-expert readers sometimes to a degree of complete incomprehensibility. Aside from that, the law could also be condensed in terms of content and wording.<sup>305</sup>

**1526.** Regarding the individual resolution rules in German law, rather short comments are sufficient. The broad conditions for the mandatory resolution regime for systemically relevant banks are acceptable like in EU law, given the variations of systemic risk. The term “threat to survival” (*Bestandsgefährdung*) should be open to an interpretation in accordance with the respective conditions of the SRM Regulation.<sup>306</sup>

**1527.** The available structural resolution tools and the provisions concerning the liability of equity and outside investors should be more or less similar to the European rules.<sup>307</sup> Different from these, however, the bail-in has so far not been designed as an independent tool which the prudential authorities can use also independently from a reorganisation plan with corresponding provisions or a statutory measure providing for it. This may be due, among others, to the difficulties in making such a tool compatible with existing EU secondary legislation.<sup>308</sup> Pursuant to German law, thus, the

<sup>304</sup> Cf. Referentenentwurf of 9 May 2014 für ein Gesetz zur Umsetzung der Richtlinie 2014/.../EU zur Festlegung eines Rahmens für die Sanierung und Abwicklung von Kreditinstituten und Wertpapierfirmen und zur Änderung der Richtlinie 82/891/EWG des Rates, der Richtlinien 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU und 2013/36/EU sowie der Verordnungen (EU) No. 1093/2010 und (EU) No. 648/2012 des Europäischen Parlaments und des Rates (BRRD-Umsetzungsgesetz).

<sup>305</sup> For instance, the existing rules contain distinctions and multiplicative rules appearing dispensable (see § 48g(7)(1-3) KWG, § 13 KredReorgG; further, e.g., § 47b(2)(1) KWG because of pp. 2 and 3; § 48l(1) KWG because of § 35 KWG). The Rettungsübernahmegesetz may also be rescinded as it no longer has any scope of application (§ 6(1)!).

<sup>306</sup> More critical: Council of Economic Experts, Annual Economic Report 2010/2011, Chancen für einen stabilen Aufschwung, Wiesbaden 2011, para. 309 (case-by-case decision on systemic relevance).

<sup>307</sup> An express rule on the liability cascade is missing, however, including a rule on the integration of the security mechanisms and the exemption of small depositors.

<sup>308</sup> Particularly, with Directive 77/91/EWG; see Ohler, [2010] GewArch, Beil. WiVerw No. 1, 47 (51).

restructuring fund plays a more prominent role as a Member State financing arrangement than is foreseen in the BRRD.

**1528.** The establishment of a restructuring fund financed by the market participants must be welcomed as such. The high target funding level must also be welcomed although it has to be left open whether it is sufficient. A critical view, however is necessary with regard to the sluggish fund capitalisation process, which makes it unlikely also in Germany that implicit guarantees can be diminished quickly.<sup>309</sup> After being established in 2011, the German restructuring fund achieved means in the amount of only EUR 1.8 billion until the end of 2013, which contrasts with a target funding level of EUR 70 billion.<sup>310</sup>

**1529.** The design of the banking contributions will have to be aligned with the SRM Regulation in the course of the implementation of the BRRD. From a competition policy perspective, this makes also sense as risk-dependent contributions have more market-adequate regulatory effects than contributions essentially calculated on the basis of the balance sheet total.<sup>311</sup>

**1530.** Finally, the Monopolies Commission is of the opinion that all beneficiary investors should pay full compensation for monetary support by the fund or State aid in the restructuring process. This obligation should include the possibility to take recourse *ex post*. Such compensation was not foreseen at the time of the bank rescue measures during the crisis, and is not foreseen in the full amount and under all circumstances to date.<sup>312</sup> It must, however, be emphasised that State aid in the context of bank restructuring measures is not part of a legitimate development policy, as is commonly the case when other State aid is granted. Rather, such State aid is support provided due to a particularly serious distortion of competition of competition, which allows banks to make the State liable for their losses.

### **3.6.1.2 Divestment or internal separation of business activities (dual banking solution)**

**1531.** A proposal quickly gaining popularity some time after the outbreak of the crisis aims at the preventive divestment of banks to create a risk shield, independent from the problem of bank resolution. This proposal is somewhat surprising given the fact that the financial crisis was spurred by the collapse of an investment bank – Lehman Brothers – to become a systemic crisis. As described above, also in Germany particularly banks with specialised business profiles fell into distress.<sup>313</sup>

**1532.** The divestment solution is based on ideas developed through various proposals outside Germany and adopted in German political debate at a relatively early stage. Against the background that deregulation in the Anglo-Saxon region in the 1980s and 1990s appeared to have failed in the financial crisis, proposals had been made according to which banks should be barred from acquiring ownership interests in hedge funds and private-equity funds and should not engage in proprietary trade on their own (USA; so-called Volcker Rule)<sup>314</sup>, or commercial banks should shield their deposits business against risks arising from other business (“ring-fencing”) (UK; recommendation in the so-called Vickers Report)<sup>315</sup>. In the following, an expert group set up by the European Commission

<sup>309</sup> Cf. the chair of the management board of FMSA, Christoph Pleister, in: Landgraf, R., An Bankpleiten kann man nicht verdienen, Handelsblatt, 3 April 2013, referring to constitutional reasons for the contribution limits. Critically, in contrast, also the Council of Economic Experts, Annual Economic Report 2010/2011, supra, para. 312.

<sup>310</sup> Cf. FMSA, press release of 22 November 2013. These funds have meanwhile even decreased; see Wefers, A./Beecken, G., Ebbe im Restrukturierungsfonds, Börsen-Zeitung, 24 April 2014, as to the reasons.

<sup>311</sup> Cf. § 1 RestruktFV.

<sup>312</sup> See, however, § 6b FMStFG.

<sup>313</sup> See paras. 1422 f., 1437 ff. above.

<sup>314</sup> § 619 of the Dodd-Frank Act: amendment to the Bank Holding Company Act of 1956 (12 U.S.C. 1841 ff.). See: Research Services of the German *Bundestag*, Aktueller Begriff: Der Glass-Steagall Act und die Bankenregulierung, Papier No. 05/10, 4 February 2010.

<sup>315</sup> Cf. Independent Commission on Banking, Final Report. Recommendations, September 2011,

recommended in the Liikanen Report that the investment banking be separated from other bank activities, though this separation should not take place as a comprehensive (institutional) separation, different from what is provided by the Volcker Rule, but leaving the option to separate the deposits-taking and investment banking activities under a common holding, which would allow the maintenance of European universal banking.<sup>316</sup> In France and Germany, dual banking laws (*Trennbankengesetze*) were passed even before the development of a proposal for uniform EU legislation, in line with the Liikanen Report, but allowing the banks to a further degree to conduct investment banking activities without separating these activities into an independent institution (particularly, market making).<sup>317</sup>

**1533.** The following comparison summarises the essential effects of the different dual banking solutions on the affected banks with deposit-taking activities (see Table VI.4).<sup>318</sup>

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[http://www.ecgi.org/documents/icb\\_final\\_report\\_12sep2011.pdf](http://www.ecgi.org/documents/icb_final_report_12sep2011.pdf); accessed: 24 June 2014. See Edmonds, The Independent Commission on Banking: The Vickers Report, Commons Library Standard Note SNBT 6171, <http://www.parliament.uk/briefing-papers/SN06171>; accessed: 24 June 2014.

<sup>316</sup> Cf. Liikanen, E. et al., High-level Expert Group on reforming the structure of the EU banking sector, Final Report, Brussels, 2 October 2012, pp. 97 ff., esp. pp. 97-99, 101-103.

<sup>317</sup> The terminology is not used consistently. In this context, market making denotes the quoting of prices at which a bank is ready to buy or sell financial instruments.

<sup>318</sup> Based on Viñals, J., et al., Creating a Safer Financial System: Will the Volcker, Vickers, and Liikanen Structural Measures Help?, IMF Staff Discussion Note, May 2013, p. 15 (Table 1); Klaus, B./Schäfer, D., Implizite Staatsgarantien verschärfen die Probleme – Trennbankensystem allein ist keine Lösung, [2013] DIW Wochenbericht No. 18, p. 9. Following the recommendations of the Vickers Commission, a bank reform act was worked out and passed at the turn of 2013/14; Financial Services (Banking Reform) Act, 2013 c. 33. The rules to implement the Volcker Rule were adopted on 10 December 2013.

**Table 4: Proposals for dual banking systems**

	<i>Volcker</i>	<i>Vickers</i>	<i>Liikanen</i>	<i>Germany</i>
<b>Reform approach</b>	<i>Institutional separation of deposits-taking/ credit activities and risky capital market activities</i>	<i>Structural separation of the deposits-financed business and other banking activities (ring-fencing)<sup>319</sup></i>	<i>Separation of proprietary trading and risky capital market activities into an independent entity<sup>320</sup></i>	<i>Separation of proprietary trading and risky capital-market activities into an independent entity</i>
Admissibility of a holding structure	No	Yes	Yes	Yes
Investments in hedge funds/private equity funds	No	No	No	No
Proprietary trading in securities/derivatives	No	No	No	No
Securities purchases based on customer order	Yes	No	Yes	Yes
Market making	Yes	No	No	Yes
Strategic investments in other institutions	Yes	With restrictions	Yes	Yes
Liabilities from deposit-taking activities towards other financial intermediaries	Yes	With restrictions	Yes	Yes
Geographic restrictions	No	Yes (outside EEA)	No	No

Source: own illustration.

**1534.** The original EU dual banking approach (Liikanen Report) pursued the objective of defusing the charges of systemic relevance without calling the universal banking systems prevalent in continental Europe fundamentally into question. Hence, the Liikanen Group recommended a mandatory separation of particularly risky trading activities exceeding certain thresholds (EUR 100 billion or 15 to 25% of the balance sheet total), while at the same time allowing these activities to remain within the same banking group. The recommendation was based on the finding that European universal banks had shifted their business focus to investment banking before the crisis, benefiting from refinancing advantages due to the combination of traditional deposits business and investment banking activities under one roof (cross-subsidisation). This raised the expectation that separating the capital market activities would increase the refinancing costs of investment banks and would, thus, make it more difficult to raise outside capital with the aim of leveraging the banks' equity. In addition, separation should reduce existing complexity and increase transparency towards the prudential authorities.<sup>321</sup> This latter point should have major significance, given the loss of confidence resulting from opacity during the crisis.

<sup>319</sup> In addition, retail banks will have to reserve extra capital adding to the regular capital requirements; see The Vickers Report, pp. 3-4, 12-13.

<sup>320</sup> In part, the separation will be dependent on the development of a convincing resolution plan, namely with regard to activities that do not relate to proprietary trading of market making; Liikanen, E. et al., High-level Expert Group on reforming the structure of the EU banking sector, supra, p. 101.

<sup>321</sup> Cf. *ibid.*, pp. 88 ff.

**1535.** In comparison with the recommendations in the Liikanen Report, the German Dual Banking Law pursues a slightly different approach.<sup>322</sup> Pursuant to the Law, the deposits and the capital-market based business should principally be separated from one another. That said, separation is mandatory only if the volume of the assets held for trading purposes or available for sale exceeds either EUR 100 billion or 20% of the balance sheet total, if the latter achieved at least EUR 90 billion in the past three business years (§ 3(2) KWG (current version)). In addition, it must be taken into account for the purposes of deciding on the separation whether the business is composed of speculative transactions in the own interest or of transactions conducted as a service for others.<sup>323</sup> This would make it possible also for banks with a purely deposits-financed business to conduct certain capital-market business activities if that is necessary within the context of the customer relationship.

**1536.** In the meantime, the European Commission has published a Proposal for a Regulation on structural measures improving the resilience of EU credit institutions.<sup>324</sup> This Proposal does not reach as far as the recommendations of the Liikanen Group, and it also differs from the German Law on shielding risk (Dual Banking Law). The proposed rules are intended to apply to banks whose total assets exceed EUR 30 billion for three consecutive years and whose total trading assets and liabilities exceed EUR 70 billion or 10% of their total assets in the same period.\* Based on EU estimates, this will affect some 30 institutions that will be prohibited from conducting – narrowly defined – proprietary trading activities (less than 5% of the trading activities).<sup>325</sup> Moreover, the competent national authorities will be competent and, in some cases, be obliged to order the separation of other risky trading activities (e.g., market making, complex securities of derivatives transactions) into an independent trading entity. To the extent that ordering structural measures are left to the competent authorities, the proposed Regulation seems to be in line with an alternative recommendation of the Liikanen Group. The latter's recommendation to separate all trading activities is not included in the European Commission's Proposal.

**1537.** The introduction of dual banking rules has been and still is controversial. The financial industry criticises politicians for interfering airily and for purely ideological reasons in a deep way with existing institutional structures and the financial system, ignoring the characteristics of investment banking and considering it as objectionable without justification. It is said that in a universal bank, traditional client business and investment banking are closely interconnected. It is claimed that providing services on a one-shop basis gives rise to significant synergies. Moreover, a not insignificant fraction of the worldwide derivatives business is said to serve to hedge client transactions. Banks could not withdraw from this business just like that and limit themselves to the deposits and loan business. As a whole, the dual banking rules would make the banking business more expensive and reduce liquidity on the capital markets. Regarding the German Dual Banking Law, it was criticised that at least the developments at EU level should be awaited before national unilateral action is taken.

**1538.** The proponents have argued so far that risk from the capital markets could spill over into the other business of the European universal banks, as had happened during the crisis. Moreover, the separation of deposits and investment banks would result in smaller entities that could be resolved more easily in a crisis.

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<sup>322</sup> Gesetz zur Abschirmung von Risiken und zur Planung der Sanierung und Abwicklung von Kreditinstituten und Finanzgruppen of 7 August 2013, BGBl. I 2013 No. 47, p. 3090.

<sup>323</sup> Bundestag, resolution proposal of the Finance Committee (7th Committee), BT-Drs. 17/13523 of 15 May 2013, p. 2.

<sup>324</sup> European Commission, Proposal of 29 January 2014 for a Regulation of the European Parliament and the Council on structural measures improving the resilience of EU credit institutions, COM(2014) 43 final.

\* Note that the English version of the proposed provision (Article 3(2): "exceed") varies slightly from the German version ("mindestens [...] belaufen"/"mindestens [...] ausmachen").

<sup>325</sup> European Commission, Commission Staff Working Document, Impact Assessment, SWD(2014) 30 final of 29 January 2014, p. 44, as well as Annexes A.5 and A.6.

**1539.** From a competition policy perspective, the Dual Banking Law must be assessed exclusively as regards its contribution to the reduction of implicit guarantees resulting from the fact that banks must not exit the market because they are perceived to be systemically relevant, given their business and the related risk.

**1540.** In that context, it must be reiterated that the implicit guarantees do not follow from the structure of a bank, but from the business relations and other links existing between the bank and other financial market participants, and the consequential contagion risk. In that regard, the size of an institution is not decisive either although, as concerns large banks, the presumption suggests itself that those banks partake to a particularly large degree (also) in business activities that give rise to systemic risk. That said, a provision directed at the inner organisation (structure) of a bank does not immediately affect the problem of contagion risk. That risk is also the same independently from whether the bank is active in its own or the client interest.

**1541.** The divestiture of banks with a deposits- and loan-financed business unit and a capital-market financed business unit does not result in banking sizes either, notably with regard to deposits and credit banks, that could be resolved more easily. The FSB considers Deutsche Bank to be a globally systemically important financial institution.<sup>326</sup> The European Banking Authority (EBA) also regards Bayerische Landesbank, Commerzbank, and DZ Bank as “other firms” which could have an impact on financial stability in the event of failure.<sup>327</sup> Even if these institutions would be compelled to spin off their entire capital-market based business, the individual banks would retain a higher business volume than could be absorbed by the fully capitalised German restructuring fund.

**1542.** It is also unlikely that the establishment of a dual banking system would allow one to isolate the traditional deposit and loan business from capital market risks. For example, particularly credit risks are traded and hedged on the capital markets (e.g., using derivatives). Conversely, securities traded on the capital market can be used for refinancing purposes such as loans. The mere separation of the financial intermediaries participating in the relevant business transactions does not change the contagion risk emanating from the business itself. Thus, the separation does not change anything in the systemic importance of institutions with capital-market based business models. For example, the systemic importance of HRE resulted in the financial crisis chiefly from the fact that a collapse of HRE group following the turbulences on the sub-prime market disrupted the *Pfandbrief* market, which was used by banks and insurances for refinancing purposes. The effects of banks and insurers following HRE’s failure would unavoidably have led to uncontrollable panic reactions by customers.

**1543.** Nevertheless, the dual banking rules should, in principle, be appropriate to reduce systemic risk because the separation of business branches – as was assumed in the Liikanen Report – allows a better allocation of the cost to the risk of the respective banking business. Thus, it will become more difficult for universal banks to obscure the risk they are exposed to in their capital-market based business by means of opaque company structures, and to shift that risk to the customers in the deposits and loan business without adequate compensation. Consequently, the separation can result in higher refinancing costs for universal banks in the capital-market based business. Then, however, the cost allocation will better reflect the risk entered into by the bank than what would be the case in the existing universal banking system (cross-subsidisation; see above, para. 1534). It is conceivable that separation consequently would make capital market activities more difficult or less attractive where the market would not pay for the risk of such activities and where the bank would shift the risk in a crisis to society.

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<sup>326</sup> Cf. FSB, Update of group of global systemically important banks (G-SIBs), 1 November 2012, Annex I (p. 3).

<sup>327</sup> Cf. EBA, Recommendation on the development of recovery plans (EBA/REC/2013/02), 23 January 2013, pp. 8-9 and Annex 1, p. 11.

**1544.** A market-adequate implementation of the German and EU dual banking rules is facilitated by the fact that they apply, or are meant to apply, to institutions whose assets or balance sheet total exceeds certain thresholds, and that the institutions may choose the holding option instead of full separation of their capital-market based business. Under these conditions, it must be assumed that only few institutions will prefer to completely abandon all capital-market activities instead of separating them pursuant to the law.

**1545.** The Monopolies Commission nonetheless takes a critical stance towards the statutorily imposed separation of proprietary trading. The prudential authorities are in a position, given their powers to evaluate the recovery and resolution plans, to enforce the measures necessary to reduce structural risks at a systemically relevant institution in the individual case.<sup>328</sup> It is unclear why the legally mandated separation is necessary in addition. To the extent that the Liikanen Report presumes an effect of such separation (clear-cut cost allocation), that effect should be small at best given the significant opacity of the market, and it should in any event be insufficient to significantly reduce the existing implicit guarantees. In contrast, it cannot be ruled out, at least at present, that the universal banks' separated business units will be more exposed to risk, and that the separation of trading activities will actually increase the implicit guarantees. This is not least indicated by the fact that SoFFin had to support only one universal bank (Commerzbank) whereas the other banks aided by SoFFin in the course of the crisis were special banks that had been able to accumulate substantial systemic risk despite their relatively clearly structured business model.

**1546.** Criticism must also be levelled at the fact that the German rules as well as the EU Proposal implement the recommendations of the Liikanen Report inconsequentially and incompletely. A separation between speculative activities in the own interest and activities as a service for others should be fundamentally inadequate as the systemic risk does not depend on whether the business is conducted in the own or the client's interest. In addition, the rules leave grey areas as regards the differentiation between own and client activities (e.g., as to hedging transactions, market making), meaning that there is a risk that financial activities will be re-labelled. Furthermore, the implementation of the separation is specifically regulated neither in the German Dual Banking Law nor in the European Commission's Proposed Regulation, which can lead to problems under M&A and tax law. Finally, it is foreseeable that the deficits of the German rules will entail significant costs and adjustment problems if a more sophisticated dual banking solution were enacted at EU level.<sup>329</sup> Therefore, it is likely that the affected banks will develop compromise solutions or even workarounds that should render the Law ineffective.<sup>330</sup>

**1547.** A more convincing approach – if one considers dual banking rules to be necessary at all – was chosen in British legislation, in so far as it does not foresee the separation of risky business activities, but rather the isolation and protection of the traditional deposits business.<sup>331</sup> The rules are less ambitious than the German and European dual banking rules, but they do protect the depositors' money in the isolated deposits business and at the same time gets round the problem of a practical separation between trading activities and other activities or between business operations in the own interest and business as a service for others. The isolation of the deposits business moreover avoids the questionable stigmatisation of trading activities as *per se* risky business and inversely increases the incentives for banks to comprehend the increased security of their deposits business as a

<sup>328</sup> § 47b (3), (4) KWG; see Möslin, [2013] ORDO 349 (365-366).

<sup>329</sup> See Viñals, J., et al, *Creating a Safer Financial System: Will the Volcker, Vickers, and Liikanen Structural Measures Help?*, supra, para. 39.

<sup>330</sup> An argument for such a development may be that the significance of proprietary trading has diminished according to industry representatives, though this went along with an increase in shadow banking activities; cf. Section 3.7 and also Section 3.8.3.

<sup>331</sup> Sec. 142B (2) of the Financial Services and Markets Act 2000 in the version of the Financial Services (Banking Reform) Act 2013, 2013 c. 33.

market-relevant advantage, to promote it and to potentially strengthen it even beyond the legal requirements.

**1548.** The Monopolies Commission assumes that politicians in Germany and the EU will cleave to the enacted or proposed dual banking rules. Against this background, it recommends on the one hand the close monitoring of the effects of the dual banking laws already existing in Germany and other jurisdictions, in particular regarding the issue whether the separated business units are less stable in stress tests as compared with traditional universal banks due to lower diversification and less available assets. On the other hand, the dual banking rules should generally be aligned more with the recommendations in the Liikanen Report so that the regulatory objectives can be achieved in the first place. Further, the separation of risky assets should be independent from balance sheet thresholds that are based on the entire banking business and not the relevant trading volume.<sup>332</sup> Apart from that, the international harmonisation of the dual banking rules should be pursued as an objective in the medium term.

### 3.6.1.3 *Deposit guarantee schemes and group-organised security systems*

**1549.** As an element of the European banking union, it is planned to develop further the European security and protection systems (in particular, the statutory deposit guarantee systems) and to potentially introduce a European statutory deposit guarantee system in the long run. These measures are relevant in the present context in so far as such security systems can render the use of implicit State guarantees superfluous.

**1550.** The deposit guarantee schemes are in essence some type of insurance for the deposits business. With the right design, they can contribute to the stability of the financial system by diminishing the risk of bank runs and allowing the diversification of liquidity risks. However, assuming a wrong design – particularly, if risk premiums are not foreseen or based on wrong risk weights – misguided incentives can arise which honour the banks' increased acceptance of risk (moral hazard). In consequence, a competitive disadvantage exists for risk-averse banks to which these banks may react with another round of accepting increased risk. This can destabilise the financial markets, following not only the explicit protection through the deposit protection schemes, but also implicit guarantees may be called upon. Thus, the design of deposit guarantee schemes requires the avoidance of competition distortions – for example, through inadequately risk-adjusted premiums.

**1551.** In the EU, Directives have provided for minimum requirements for deposit guarantee schemes for quite some time.<sup>333</sup> In Germany, there is a multi-layered deposit guarantee system in which the statutory minimum protection for deposits and securities under the Deposits Protection and Investor Compensation Law is supplemented by voluntary security systems (deposits protection funds) established by the banking associations. Further, the security funds of the savings and cooperative banks insure the relevant institutions in their entirety. Deposit protection insures demand deposits (current accounts), savings deposits (pass books and savings certificates, if issued to a registered holder), time deposits, and registered bonds, notes, and securities transactions, excluding the deposits of banks, the Federal State and the *Länder*, as well as securities issued as bearer instruments (e.g., bearer bonds, including ABS).

<sup>332</sup> Cf. the President of BaFin, Elke König, in: Rexer, A/Zydra, M., *Banken sollten selber haften*, *Süddeutsche Zeitung*, 13/14 October 2012: "All large and complex banks have a corresponding risk potential. [...] Experience shows, however, that the main risks emanated from medium institutions that had overestimated their capabilities." [*"Alle großen und komplexen Banken haben ein entsprechendes Risikopotenzial. [...] Die Erfahrung zeigt aber, dass die Hauptrisiken von mittelgroßen Instituten ausgingen, die sich überschätzt haben."*]

<sup>333</sup> Directive 94/19/EEC of the European Parliament and the Council on deposit-guarantee schemes, OJ L 135 of 31 May 1994, p. 5, and Directive 97/9/EC of the European Parliament and of the Council on investor-compensation schemes, OJ L 84, 26 March 1997, p. 22.

**1552.** The volume of the security systems existing in Germany can be assessed only to a limited extent based on public information.<sup>334</sup> The existing security systems are designed to stabilise institutions in individual cases; they are not designed to cope with the default of multiple institutions in the context of a systemic crisis.<sup>335</sup> Consequently, they do not cover all currently existing deposits even though they must have a sufficient volume to effectively reduce the risk of a bank run or the associated dangers and to strengthen confidence in the banks.<sup>336</sup> However, the existing systems generally cannot avert the distress of larger or systemically relevant institutions. In the financial crisis, most of the existing systems turned out to be overcharged. Except for the cooperative banks' security system, no security system in Germany was able to absorb the costs associated with the materialisation of systemic risk in the individual banking groups. The private banks' deposit protection fund had to be sustained with State aid.<sup>337</sup> The savings banks' security system failed more or less completely as a market economy security system. The rescue of the *Landesbanken* and even of Sparkasse KölnBonn was essentially only possible through State aid, and this even to the extent that the savings bank group contributed to the rescue.<sup>338</sup> Thus, the German institutional and deposit security systems had to be supported – however, using tax funds – by way of individual aid for banks and institutionally using the Sonderfonds Finanzmarktstabilisierung (SoFFin).<sup>339</sup>

**1553.** The minimum requirements for the statutory deposit insurance systems under EU law were recently increased, and EU-wide financing conditions were put in place for the statutory deposit guarantee mechanisms for the first time.<sup>340</sup> This measure is meant to take account of the fact that the existing fragmented security systems were insufficient to maintain investor confidence and financial stability in the financial crisis.<sup>341</sup> Hence, the new Directive is meant to harmonise more strongly the existing national systems of statutory deposit insurance, and to organise them in a more solid and credible manner. In the context of establishing the EU banking union in 2012, deposit protection was defined as a pillar of that banking union, but it is still open whether the existing security systems will be supplemented or replaced in the long run by a joint statutory deposit insurance system.<sup>342</sup>

<sup>334</sup> However, see the record of assets of the *Bund* as to statutory deposit insurance, [http://www.bundesfinanzministerium.de/Web/DE/Themen/Oeffentliche\\_Finzen/Bundeshaushalt/Haushalts\\_und\\_Vermoegensrechnungen\\_des\\_Bundes/haushalts\\_vermoegensrechnungen\\_des\\_bundes.html](http://www.bundesfinanzministerium.de/Web/DE/Themen/Oeffentliche_Finzen/Bundeshaushalt/Haushalts_und_Vermoegensrechnungen_des_Bundes/haushalts_vermoegensrechnungen_des_bundes.html); accessed: 24 June 2014.

<sup>335</sup> Cf. Pleister, C., speaker of the steering committee of the Federal Agency for Financial Market Stabilisation, as quoted in: Budget Committee of the German Bundestag, Minutes No. 17/29 on the Hearing of 6 October 2010, p. 15.

<sup>336</sup> In principle, statutory deposit insurance covers 100% of the deposits up to the amount of EUR 100,000 and 90% of securities transactions up to the value of EUR 20,000, § 4 EAEG. Regarding the ratio of deposit insurance and deposits, see European Commission, Scenario Analysis: Estimating the effects of changing the funding mechanisms of EU Deposit Guarantee Schemes, DGS Project, Final Report, February 2007; more recently: association of German Banks, Einlagenschutz je Privatbankkunde in Deutschland von 2011 bis 2025 (je EUR 1.000), <http://bankenverband.de/service/einlagensicherung/informationen-zur-einlagensicherung/grafik-einlagenschutz-sicherungsgrenzen-bleiben-weiterhin-hoch>; accessed: 24 June 2014.

<sup>337</sup> See European Commission, Decision of 21 January 2009, N 17/2009, SoFFin guarantee for the German deposit guarantee scheme for private banks - Germany.

<sup>338</sup> As to the case of Sparkasse KölnBonn, see European Commission, Decisions of 4 November 2009 and 29 September 2010, C 32/2009 – Germany. Sparkasse KölnBonn.

<sup>339</sup> European Commission, Decision of 21 January 2009, N 17/2009 - SoFFin guarantee for the German deposit guarantee scheme for private banks - Germany, particularly, paras. 3 ff.

<sup>340</sup> Directive 2014/49/EU of the European Parliament and the Council on deposit guarantee schemes (recast), OJ L 173, 12 June 2014, p. 149 (Deposit Insurance Directive).

<sup>341</sup> European Commission, Proposal of 12 July 2010 for a Directive .../.../EU of the European Parliament and of the Council on deposit guarantee schemes [recast], COM(2010) 368 final (Neufassung), explanatory statement, p. 2.

<sup>342</sup> Cf. Van Rompuy, H., press release of 26 June 2012 on the Report: “Towards a genuine Economic and Monetary Union”, EUCO 120/12, p. 4; Barnier, M., MEMO/13/251 of 19 March 2013 concerning the trilogue agreement on the development of a Single Supervisory Mechanism. The pillars, however, are labelled inconsistently, cf. para. 1474.

**1554.** The introduction of a joint European deposit insurance is opposed by parts of the financial industry. The reason is that it is feared that the funds of the German security systems might be used without further ado to compensate for the failure of other European banks. The mutualisation of risks to the detriment of German credit institutions would set incentives for the increased acceptance of risk (moral hazard problem) and distort competition between the European banks because particularly banks from Member States in arrears with the establishment of a national deposit insurance scheme would profit from the common deposit insurance. Both the savings bank association and the cooperative bank association emphasise that small regional institutions should not pay for the risky operations of internationally active investment banks. Instead of a common deposit insurance system, the associations prefer the harmonisation of the national deposit insurance systems.

**1555.** The Monopolies Commission does not generally oppose the further evolution of deposit insurance at EU level as such, but it considers it necessary that the concerns of the German banks be taken into account in the design of that system. It therefore welcomes the decision not to establish a common statutory deposit guarantee system for all banks at this stage, and to only harmonise the systems further at the national level, which leads to higher uniform minimum standards for the protection of savings deposits.

A common statutory deposit insurance would contribute to uniform competitive conditions (level playing field), but it would do so at the price that competition between the European banks and banking groups for the creation of powerful and confidence-enhancing security systems is restrained. This competition must generally be viewed positively on the basis of the German experience with the establishment of competing security systems. Against this background, a common deposit insurance designed for the European financial market appears to make sense only for banks that are systemically relevant at EU level. Regarding these banks, it must be taken into account that the systemic risk associated with their business can radiate across the EU into the financial system. In contrast, it is rather unlikely particularly in the case of the primary institutions in the associated groups of the savings and cooperative banks that there is a risk of such systemic repercussions.

In any event, the incorporation of the German security systems in a European deposit insurance system should take place in a competitively neutral fashion. In that regard, on the one hand, barriers would have to be erected for banks not contributing to the system so that they would not gain access to the funds of the security system. The use of funds to their benefit would be to the detriment to the banks contributing so far and not be justified. On the other hand, it is necessary that the national security systems are also available for members from other Member States with a subsidiary or a branch in Germany, in order to prevent further fragmentation of the financial market.

**1556.** Regarding the scope of the joint or harmonised statutory deposit insurance, only limited recommendations are possible at this stage. Pursuant to the current legislation, the (*ex ante*) usable target level is expected to be 0.8% of the refundable deposits; and the banks are expected to make additional (*ex post*) contributions in the amount of up to 0.5% of the refundable deposits if needed.<sup>343</sup> The coverage level will continue to be EUR 100,000.<sup>344</sup>

Viewed together with the provisions on the liability cascade, these requirements appear alarmingly low. Accordingly, the statutory and private insurance systems would generally have to be able to absorb even the failure of multiple banks in the event of a systemic failure of parallel business models (too many to fail).<sup>345</sup> It cannot be assumed that enough outside capital would otherwise be available for a write-down or conversion in order to avoid taking recourse to the resolution financing

<sup>343</sup> Article 2(1) No. 11, Article 10(2) and (8) Deposit Insurance Directive. The Proposal originally set the target level at 1% of the refundable deposits.

<sup>344</sup> Article 6(1) Deposit Insurance Directive .

<sup>345</sup> The Spanish cajas provide an example, cf. Liikanen, E. et al., High-level Expert Group on reforming the structure of the EU banking sector, *supra*, pp. 65-66.

mechanisms or State aid. That being said, the risk of taking recourse in that way must be set against the large burden for the affected banks (also: banks that are not systemically relevant) that would be associated with complete security, and against the low likelihood of widespread failures of deposit-taking banks.<sup>346</sup> The balancing exercise, however, would be fraught with major uncertainties. Thus, the current rules can apparently be defended, but they are not unobjectionable in view of what was experienced in the financial crisis.

The Monopolies Commission takes the view that the current rules on the target funding level and the contributions should be no means be regarded as final. It welcomes the European Commission's mandate to continuously review the rules on the amount of the deposit insurance and to adjust the relevant provisions on the coverage level after the establishment of the deposit insurance system.<sup>347</sup> Apart from that, it is indispensable that the rules are implemented swiftly and completely and that steps are taken to ensure that also the private security systems are well capitalised. In order to determine quickly based on market reactions whether the existing system needs to be adjusted, the transparency of all systems should moreover be increased (e.g., through harmonised and standardised depositor information).

**1557.** The possibility pursuant to the SRM Regulation to use resolution funds to support deposit insurance systems in distress must be seen critically.<sup>348</sup> That use is not in line with the main objective of the resolution fund to support resolution financing. It could create a joint deposit insurance mechanism although this has not been defined as an objective so far. In any case, such a use should take place only within a limited time frame and under the condition that the beneficiary security systems pay back the received money completely.

### ***3.6.2 Internal growth: limitation of hazardous activities***

**1558.** The above rules directly targeting the existing implicit guarantees are complemented by regulatory requirements making it more difficult for banks to accumulate excessive risk in their business. Such rules linked to the amount of business of the individual undertaking can be categorised as rules on internal growth in the competition context, as opposed to rules concerning company takeovers (see Section 3.6.3).

#### ***3.6.2.1 Capital and liquidity requirements***

**1559.** Sufficiently stringent capital and liquidity requirements are considered to be decisive to put a block on the development of implicit guarantees. In addition, they are a buffer that can neutralise existing implicit guarantees in so far as these guarantees cannot be eliminated through the establishment of a resolution mechanism and as deposit insurance systems do not provide sufficient insurance. In that context, capital requirements are central.

#### ***Functions and deficiencies of capital requirements against the backdrop of previous crises***

**1560.** Capital requirements for banks fulfil different functions. On the one hand, they have the function to limit risk or to curb activities. Since banks have to underpin their risk with capital in a pre-defined amount, this constrains their appetite to seek and accept excessive risk (particularly, moral hazard; avoidance of so-called gambling for resurrection). On the other hand, capital requirements have a loss compensation or buffer function. They are meant to ensure that losses accruing in ongoing business operations are compensated (going concern) and that creditor claims are satisfied in the case

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<sup>346</sup> Cf. Impaired Assets Communication, para. 6, concerning the associated difficulties.

<sup>347</sup> Cf. Article 6(6) and 7, Article 10(10) Deposit Insurance Directive.

<sup>348</sup> See Article 79(5) SRM Regulation.

of bankruptcy (gone concern). Additionally, they are associated with the prospect of reducing the risk of pro-cyclical effects (particularly, bank runs).

**1561.** The crises so far, however, have shown that the above-mentioned functions of capital requirements can conflict with each other and that pro-cyclical effects cannot be ruled out on the basis of these requirements to date. The core problem is seen in the banks' inclination to retain only capital in the amount of the regulatory minimum. Consequently, however, no capital is in fact available for loss compensation in a crisis. If a bank incurs losses in a crisis, it is rather obliged to quickly increase its capital or to lower its risks in order not to violate the capital rules and to trigger regulatory sanctions. However, increasing capital is hardly possible in a crisis whereas distress sales (fire sales) are liable to further heat up the drop in prices and value due to the crisis. Thus, the risk of pro-cyclical effects is even increased by the attempt to comply with the capital rules in a crisis.

**1562.** This mechanism became apparent recently in the financial crisis. In that situation, banks were forced to quickly sell large amounts of risky ABS because the risk of losses associated with these securities increased dramatically within an extremely short period of time. Consequently, the market for those ABS collapsed largely. Similarly, the bank defaults during the Great Depression (1931) are attributed to a lack of capital. In Germany, strong pro-cyclical effects appeared also in the "Founders' Crash" (*Gründerkrach*; 1873), and just like in the recent financial crisis because of rampant speculation.

**1563.** The latest financial crisis moreover exposed problems with regard to the capital requirements, which were based on too narrowly defined factors (specifically pursuant to Basel II). This was because they were only designed with regard to the default risks of individual banks, but neglected business-related risks following from systemic contagion for other market participants. In addition, the determination of the risks, which had to be supported with capital, was based on problematic and partly anticompetitive requirements – notwithstanding special supervisory rules (prudential filters). In that regard, fair value accounting according to IFRS and US GAAP is a particular relevant example.

In principle, IFRS accounting allows one to take into account future changes in value.<sup>349</sup> However, particularly the account treatment of unrealised gain from capital-market based operations can induce accounting practices that do not sufficiently accommodate the risk of drops in market value due to a crisis. In that respect, fair value accounting can further pro-cyclical market behaviour in a crisis situation. This implies that an issue attains fresh importance, which the German imperial Legislature had already sought to remedy when it introduced the principle of prudence and initial value in the Commercial Code (*Handelsgesetzbuch*) following the Founders' Crash.<sup>350</sup>

**1564.** Additional uncertainty arises from the fact that existing banking regulation allows European banks to choose between the standard risk approach and the use of internal risk models to determine the risk to be supported with capital. The standard risk approach is available to all banks and requires risk valuations by rating agencies with regard to certain risks.<sup>351</sup> The use of internal risk models is more demanding, but obliges the banks to use external ratings only to a lesser degree.<sup>352</sup> In the United States, the use of internal risk models is required by law with a view to limiting the exposure of large bank holdings to external ratings.<sup>353</sup> The Monopolies Commission nonetheless prefers the widest

<sup>349</sup> See Kütting/Lam, [2013] DB 1737, as concerns future prospects in the accounting under HGB and IFRS.

<sup>350</sup> Cf. Zeitler, [2012] WM 673 (675-676) on further points of critique that are here of secondary relevance only (e.g., valuation uncertainty where the market value must be estimated). The principle of prudence, however, is subject to limitations also under the Commercial Code (see §§ 255(4), 340e(3)(1) HGB; specifically with regard to non-realised profits, however, see also § 340e(4) HGB).

<sup>351</sup> See Articles 111 ff. of Regulation 575/2013 on the standard approach; regarding the use of internal ratings to determine the risk weight, see Articles 135 ff. of Regulation 575/2013.

<sup>352</sup> See Art. 142 ff. of Regulation 575/2013 on the internal ratings-based approach (IRB approach).

<sup>353</sup> 12 CFR Ch. II, Pt. 225, App. G (1–1–13 Edition) for bank-holding companies with consolidated total assets of at least USD 250 billion.

possible use of the standard approach, as the prudential authorities are better equipped to analyse risk determinations based on this approach. In that regard, it must be welcomed that the Basel Committee ponders the option to require banks using internal models to provide at least some risk information also based on the standard approach.<sup>354</sup>

**1565.** The financial crisis demonstrated that the ever more sophisticated risk calibration within the framework of internal models does not capture the risk better in all cases, but that it can result in systemic undervaluations of risk and, consequently, in insufficient bank capital provisions. On the one hand, this was caused by technical shortcomings in the risk models, for example, the fact that certain types of risk were merely incompletely addressed. However, the premise underlying the models – i.e., that they are capable of reflecting the risk structure of individual bank operations in their entirety – was problematic as well.<sup>355</sup> On the basis of this premise, the prudential authorities are entitled to approve internal risk models and to use the valuation results for their prudential measures. However, if anything, then the individual banks are only capable of valuating the risks threatening their survival correctly. In contrast, the crisis has shown that the prudential authorities must focus their attention not on the risks threatening the survival of a bank, but rather on the risks going beyond and affecting systemic stability. If such risks materialise, this can fall back on the bank and may increase or reinforce the threat to the bank's existence.

In addition, the possibility to use internal model provides significant incentives to the banks to undervalue their risks in order to conduct a maximum of business with a minimum of capital. The Basel Committee's reviews in 2013 revealed that the valuations of portfolios in the trading and banking books differed significantly from one another, i.e., up to 70% for the trading book portfolio and up to 40% for the banking book portfolio.<sup>356</sup> However, already differences in the valuations of the banking book portfolio can account for two percentage points in the submitted capital ratios. For investors (depositors) and even the owners, it is virtually impossible to comprehend the valuations or the underlying calculations. Such leeway in the determination of risk-based capital ratios is objectionable and undermines the central liability function of capital.

**1566.** Capital regulation, thus, has been incomplete so far despite its alleged precision, and it has been fraught with substantial uncertainty. The capital quotas were too low to cover individual existential threats to the extent possible. They were to an even lesser extent sufficient to cover systemic risks to the extent possible. Effective limitations on risk were not guaranteed by the relevant provisions. Finally, there were no mechanisms in place to counter the increase of risk through procyclical market behaviour. The adjustments to the Basel II recommendations following the crisis ("Basel 2.5") did not completely remedy these deficiencies although they removed the most problematic options that banks had used up to the crisis for arbitrage between the trading and the banking book.<sup>357</sup>

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<sup>354</sup> See Basel Committee on Banking Supervision, *Fundamental Review of the Trading Book: A Revised Market Risk Framework*, Consultative Document, October 2013, as to market risk.

<sup>355</sup> Critically with regard to the system of risk modelling, see Scientific Advisory Council at the Federal Ministry for Economic Affairs, *Reform von Bankenregulierung und Bankenaufsicht nach der Finanzkrise*, Opinion No. 03/10, April 2010.

<sup>356</sup> Cf. Basel Committee on Banking Supervision, *Regulatory Consistency Assessment Programme (RCAP), Analysis of Risk-Weighted Assets for Credit Risk in the Banking Book*, July 2013; and *Analysis of Risk-Weighted Assets for Market Risk*, January 2013, revised February 2013. According to the Basel Committee, the share of risk-weighted assets is higher at US banks than at European banks, but particularly German and French banks use internal models for evaluating risk. Besides, European banks tend to evaluate risks more aggressively than non-European banks.

<sup>357</sup> Cf. Basel Committee on Banking Supervision, *Enhancements to the Basel II Framework*, July 2009; *Guidelines for Computing Capital for Incremental Risk in the Trading Book*, July 2009; and *Revisions to the Basel II Market Risk Framework*, February 2011. These recommendations provided, among others, for higher capital requirements for ABS and derivatives, and limited the transfer of risk to SIV without adequate capital backing (particularly, increase of the risk weight for liquidity commitments during the business year).

*Assessment of the current capital requirements*

**1567.** The capital requirements that have been in force in the EU since 1 January 2014 include new amendments concerning the three issue areas identified above (para. 1566).<sup>358</sup> As compared with previous law, the competitive conditions are harmonised to a far wider extent by means of a Regulation and detailed provisions in a Directive, which will apply to roughly estimated 8,300 European banks.

**1568.** The new rules include three elements that are of particular relevance in the present context. They contain more stringent capital requirements strengthening the capital base in the event of losses, they introduce a leverage ratio to limit the risk in-take more clearly, and they allow for the issuance of contingent convertibles (CoCos), i.e., for bonds that are converted into equity capital if a trigger event occurs, and which are intended to constrain the development of pro-cyclical sales spirals. The new rules will apply at different stages, which is supposed to allow the banks to strengthen their capital base and to avoid the risk of credit contractions. Such credit contractions had been feared in case of a rapid legal change and could exacerbate the situation in some Member States.

– Capital –

**1569.** The new capital requirements for banks considered to be systemically relevant can summarily be illustrated as follows (see Table VI.5).<sup>359</sup>

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Regarding the implementation in EU law, see Directive 2009/111/EC (CRD II) and Directive 2010/76/EU (CRD III).

<sup>358</sup> See Article 4(1) No. 118 and Article 72 of Regulation 575/2013 on the definition of capital.

<sup>359</sup> Table based on: Schulte-Mattler/Manns, [2011] WM 2069 (2072).

Table 5: Overview of capital ratios for systemically relevant institutions pursuant to CRR/CRD IV

Total capital ratio including buffers <sup>360</sup>			7.5%	8%	11.25%	12.5%	14,375%	16.5%	16.5%	16,50%
Tier 2 capital			2%	2%	2%	2%	2%	2%	2%	2%
Additional Tier 1 capital			1.5-2% <sup>361</sup>	1.5% <sup>362</sup>	1.5%	1.5%	1.5%	1.5%	1.5%	1.5%
Common equity Tier 1 capital			4% <sup>363</sup>	4.5% <sup>364</sup>	4.5%	4.5%	4.5%	4.5%	4.5%	4.5%
Systemic risk buffer			(1-3%) <sup>365</sup>	(1-5%)	(1-5%) <sup>366</sup>	(1-5%)	(1-5%)	(1-5%)	(1-5%)	(1-5%)
Max. G-/O-SRI buffer <sup>367</sup>			---	---	2% <sup>368</sup>	2%	2.625% <sup>369</sup>	3.5% <sup>370</sup>	3.5%	3.5%
Max. countercycl. Puffer			---	---	0.625% <sup>371</sup>	1.25% <sup>372</sup>	1.875% <sup>373</sup>	2.5% <sup>374</sup>	2.5%	2.5%
Capital conservation buffer			---	---	0.625% <sup>375</sup>	1.25% <sup>376</sup>	1.875% <sup>377</sup>	2.5% <sup>378</sup>	2.5%	2.5%
			<b>2014</b>	<b>2015</b>	<b>2016</b>	<b>2017</b>	<b>2018</b>	<b>2019</b>	<b>2020</b>	<b>2021</b>

<sup>360</sup> The total capital without buffers equals the so-called solvability co-efficient. It should be borne in mind that German law may require additional capital even beyond the European capital requirements in the individual case, § 10(3), (4) KWG.

<sup>361</sup> Article 465(1) lit. b of Regulation 575/2013.

<sup>362</sup> Article 92(1) of Regulation 575/2013.

<sup>363</sup> Article 465(1) lit. a of Regulation 575/2013. It is possible to provide for a common equity Tier 1 capital ratio between 4 and 4.5%. That said, the Tier 1 capital ratio must stay under the limit of 5.5 to 6% and may not go beyond.

<sup>364</sup> Article 92(1) of Regulation 575/2013.

<sup>365</sup> Article 133(3) in conjunction with Article 162(6) of Directive 2013/36/EU, § 10e in conjunction with § 64r(6) KWG in the version of the CRD IV-Umsetzungsgesetz. The systemic risk buffer can also be set for risk positions only in the relevant Member State for risk positions in third countries, amounting to up to 5% or 3% respectively (Article 133(8), (13), (18) of Directive 2013/36/EU). This buffer regularly does not provide for extra capital in addition to the G- and O-SRI buffers.

<sup>366</sup> Article 131(14)-(17), Article 133(3), (5), (7) in conjunction with Article 162(5)(1) and Sec. 6 of Directive 2013/36/EU; § 10e(1), (4) KWG (geographically limited systemic risk buffer).

<sup>367</sup> G-SRI-Puffer = buffer for globally systemically relevant institutions; O-SRI buffer = buffer for other systemically relevant institutions.

<sup>368</sup> Article 131(5), (8), (14) lit. a in conjunction with Article 162(5)(1) of Directive 2013/36/EU; § 10g(1) in conjunction with § 64r(8) KWG (as to O-SRI).

<sup>369</sup> Article 131(4), (9), (14) lit. a in conjunction with Article 162(5)(2) lit. c of Directive 2013/36/EU; § 10f(1) in conjunction with § 64r(7) No. 3 KWG (as to G-SRI).

<sup>370</sup> Article 131(4), (9), (14) lit. a in conjunction with Article 162(5)(2) lit. d of Directive 2013/36/EU; § 10f (1) in conjunction with § 64r(7) KWG (as to G-SRI).

<sup>371</sup> Article 160(2) lit. b of Directive 2013/36/EU; § 64r(5) No. 1 lit. b KWG.

<sup>372</sup> Article 160(3) lit. b of Directive 2013/36/EU; § 64r(5) No. 2 lit. b KWG.

<sup>373</sup> Article 160(4) lit. b of Directive 2013/36/EU; § 64r(5) No. 3 lit. b KWG.

<sup>374</sup> Article 136(4)(1), Article 130(1) in conjunction with Article 140 of Directive 2013/36/EU, § 10d KWG; Article 92(3) of Regulation 575/2013. The ratio of the countercyclical buffer is generally set between 0% and 2.5%, yet it is set for the individual institution and can also exceed 2.5% (cf. Article 136(4)(2), Articles 137, 140(2), (3) of Directive 2013/36/EU).

<sup>375</sup> Article 160(2) lit. a of Directive 2013/36/EU, § 64r(5) No. 1 lit. a KWG.

<sup>376</sup> Article 160(3) lit. a of Directive 2013/36/EU, § 64r(5) No. 2 lit. a KWG.

<sup>377</sup> Article 160(4) lit. a of Directive 2013/36/EU, § 64r (5) No. 3 lit. a KWG.

<sup>378</sup> Article 129(1) of Directive 2013/36/EU, § 10c(1) KWG.

Progressive adjustment and introduction of corrective and subtractive positions <sup>379</sup>	20-100%	40-100%	60-100%	80-100%	100%	100%	100%	100%
Progressive removal of grandfathering <sup>380</sup>	20-40%	30-60%	40-80%	0-50%	60-100%	70-100%	80-100%	90-100%
Progressive abolition of non-conform additional capital <sup>381</sup>	0%	25%	50%	100%	100%	100%	100%	100%
Imputation of State aid <sup>382</sup>	100%				0,00%			

Source: own illustration.

**1570.** The capital ratios above are calculated by putting the respective regulatory capital (common equity Tier 1 capital, additional Tier 1 capital, Tier 2 capital) in relation to the risk-weighted assets (“total risk exposure amount”).<sup>383</sup> This puts the positions that can be written down (liability potentials) in relation to the positions that must be written down (risk potentials). The following formula applies:

$$\frac{\text{Equity}}{\text{Risk – weighted assets}}$$

The asset classes have different functions in regard of potential losses. The common equity Tier 1 capital serves primarily as a buffer for operational losses and to avoid failure (going concern), the Tier 2 capital is used in the event of failure (gone concern).

**1571.** The new rules, as described in the paragraph above, match the Basel Committee’s recommendations to a large extent (i.e., Basel III). The newly introduced capital conservation buffer is specifically reserved for crisis periods in which it can be drawn down. The countercyclical buffer must be built up in parallel to the acceptance of risky business in economic upturn periods and likewise counters the excessive loss of capital in periods of crises.<sup>384</sup> The extra capital amounts for globally systemically relevant institutions address the systemic risk emanating from these institutions. In addition to the recommendations of the Basel Committee, the EU has introduced extra amounts for nationally systemically relevant institutions as well as a macro-prudential systemic risk buffer. That said, only the highest of the three buffers has to be fulfilled as a rule. Because of the newly introduced buffers, the new provisions increase the statutorily mandated total capital ratio, though this increase is rather moderate.<sup>385</sup> For most banks, stricter requirements follow chiefly from the fact that the relevant capital must be of better quality in the future. The category of Tier 3 capital falls away completely.

**1572.** Aside from this increase of risk-weighted minimum capital ratios, the risk weights used for the calculation of capital were changed as well in reaction to the financial crisis. By way of example, reference may be made to ABS. Already in the context of Basel 2.5, the risk weights for re-securitisations were more or less doubled to accommodate the typically higher risk as compared to common ABS. If a bank does not meet the stricter requirements also for internal risk assessments, the ABS must nowadays be backed completely with capital, i.e., they have a risk weight of up to 1250%.

<sup>379</sup> Articles 478(1), 481 of Regulation 575/2013.

<sup>380</sup> Articles 484-486 of Regulation 575/2013.

<sup>381</sup> Article 494 of Regulation 575/2013.

<sup>382</sup> Article 483 of Regulation 575/2013.

<sup>383</sup> Article 92(2) of Regulation 513/575.

<sup>384</sup> Recitals 79-80 of Directive 2013/36/EU. On the asset side (credits and loans), higher value adjustments resemble that buffer in good times as they help to absorb losses in the downturn (dynamic loan loss provisioning).

<sup>385</sup> Abstaining from building up the capital conservation buffer and the countercyclical buffer does not violate the capital rules, but it only limits the possibility to distribute profits and earnings; cf. Article 141 of Directive 2013/36/EU, § 10i KWG.

In the EU, a retention of at least 5% of the credit risk has additionally been introduced for the originator of an ABS position. As concerns derivatives, adjustments were made primarily regarding the calculation methodology and the asset-backing of the risk of counterparty default since a large part of the losses in the OTC business in the financial crisis was due to the decline of the counterparties' creditworthiness. An additional capital requirement reflecting the risk of declining creditworthiness was consequently introduced for OTC transactions not involving a central counterparty, i.e., the so-called Credit Valuation Adjustment (CVA).<sup>386</sup>

These measures and the banks' improved risk management ensure that risk positions are backed with more capital. They complement the above-mentioned quantitative increase of the regulatory minimum capital ratios, meaning that the actually available non-risk-weighted capital backing for some risk positions is improved further.

**1573.** The Monopolies Commission, on principle, welcomes the capital requirements, which have been tightened from both a quantitative and a qualitative viewpoint. By increasing the robustness of the banks, they are an element reducing systemic risk and, thus, make it less likely that implicit guarantees must be called upon. This will lower the value of such guarantees and will reduce existing competitive advantages to the benefit of systemically relevant institutions. Elements to be welcomed include, in particular, the introduction of capital buffers absorbing unexpected losses and extra amounts related directly to the systemic relevance of some institutions. It is, however, an open question whether the capital is increased enough to put an obstacle to the development of implicit guarantees.

**1574.** The capital conservation buffer is meant to enable banks to write down losses in the operative business without having to react with an immediate shortening of their balance sheets (deleveraging) or the redeployment of assets. Thereby, it improves the resilience of the institutions and reduces contagion risks, and in so far may be viewed positively from a competition policy perspective. The general objective of the countercyclical risk buffer, i.e., putting a limitation on the excessive growth of credit in times of economic boom, must be welcomed as well. The national prudential authorities will have the task of setting the amount of the countercyclical buffer quarterly for the risk positions located in the respective Member State. In that context, they are expected to take into account especially deviations from the long-term trend of the ratio of credit to GDP, and any other variables relevant to financial stability. It will be seen to what extent such fine-tuning of banking regulation is possible. It is important, however, that the determination is based on precise criteria in order to limit the national authorities' discretion in a sensible way. It must be noted as a positive element that the weighted average of the national countercyclical buffers will apply to internationally active institutions. Thus, it can be avoided that a race to the bottom takes place with a view to supporting domestic institutions, which would distort international competition.

**1575.** Another positive feature is the requirement of extra capital buffers for systemically relevant institutions, which constitute a price for the external effect of systemic relevance. The calculation of the buffers based on the criteria size, interconnectedness, substitutability, and – in the case of globally systemically relevant institutions – cross-border activity<sup>387</sup> appears adequate, as does the scaling of the buffers. When a bank internalises systemic risks through the higher capital ratios, these risks will become apparent to the market – at least to the extent that they are passed on to the banks' clients. This could increase the incentives for the banks to grow at a slower pace or to reduce their own

<sup>386</sup> Cf. Deutsche Bundesbank, Basel III - Leitfaden zu den neuen Eigenkapital- und Liquiditätsregeln für Banken, 2011, pp. 22 f.

<sup>387</sup> Cf. Basel Committee on Banking Supervision, Global systemically important banks: assessment methodology and the additional loss absorbency requirement, Rules text, November 2011; A framework for dealing with domestic systemically important banks, October 2012; Global systemically important banks: updated assessment methodology and the higher loss absorbency requirement, July 2013. See also Article 131 CRD IV.

systemic relevance. This incentive is increased further through the requirement that the buffers – like all other buffers – must be composed of Tier 1 capital. On the whole, the systemic risk buffers may be an element reducing the systemic risk associated with these institutions and may help to reduce the distortions of competition associated with implicit guarantees in the banking sector.

**1576.** Supplementing these buffers and in addition to Basel III, a capital buffer for systemic risk can be introduced by the national prudential authorities in the EU, which is supposed to counter long-term, non-cyclical systemic or macro-prudential risks that could lead to a serious disturbance of the national financial system and the domestic real economy. The buffer can be imposed for risk positions located in the respective Member State, another Member State of the European Economic Area, or another State. It must amount to 1% and usually no more than 5% of the capital; and up to 3%, it must only be notified to the European Commission, the ESRB, EBA and the competent and designated authorities of the Member States concerned. Higher buffers are subject to a special procedure at EU level. National regulators retain the possibility to recognise the buffer ratios imposed in other Member States such that domestic institutions must comply with the buffers in other Member States for claims in these Member States.

The systemic risk buffer must generally be viewed positively as it addresses systemic risk that does not arise out of the systemic relevance of individual institutions or cyclical developments and that is not covered by other buffers. The introduction of additional national systemic risk buffers can contribute to the fragmentation of the internal market. That said, it seems justified to take that risk into account to the extent that this reduces systemic risk and, hence, the danger that implicit guarantees are being used. With regard to the problem of implicit guarantees, it is not reasonable to bar higher capital ratios with regard to specific risks. Therefore, Member States should generally retain the possibility to impose a systemic risk buffer of more than 3% if they simply notify the relevant authorities.

**1577.** These amendments and the increase of the regulatory minimum capital seem to be extensive *prima facie*. Still, it must be emphasised that the system of risk-based capital regulation has not changed fundamentally. Since the aforementioned minimum requirements still relate to risk-based assets, the actual – i.e., the non-weighted – capital ratio of the institutions continues to be significantly lower. If one compares both capital measures at German banks, some enormous differences come to light. For instance, the average capital ratio of German deposits banks, as related to risk-weighted assets, was 19.16% at the end of 2013, and only 5.45% as related to non-risk-weighted assets.<sup>388</sup> This means that the banks finance their assets on the average with outside capital by almost 95%.<sup>389</sup>

**1578.** Against this background, the question remains whether the current capital requirements are adequate. For smaller banks, this may generally be the case because these banks usually did not have to call on State aid in the financial crisis. It is, however, problematic that the requirements for systemically relevant banks fall in some respect significantly short of what some experts have called for after the financial crisis.<sup>390</sup> For example, a globally systemically relevant bank must only have a capital ratio that is at most 3.5% higher than that of a small bank even though the business volume of such banks – including the risk associated with that business – is often considerably higher. It is questionable whether the currently applicable requirements would be able to absorb systemic risk in a future crisis that is as serious as the recent financial crisis. In addition, if the capital requirements for banks benefiting from an implicit guarantee are not risk-adequately increased, this prolongs that

<sup>388</sup> IMF, Financial Soundness Indicators, <http://elibrary-data.imf.org/Report.aspx?Report=4160276&Country=134>; accessed: 24. June 2014.

<sup>389</sup> This is not the Leverage Ratio discussed below, which also addresses out-of-balance exposures and therefore is a still lower limit (cf. paras. 1592 ff.).

<sup>390</sup> Cf. z. B. Admati, A./Hellwig, M., *The Bankers' New Clothes: What's Wrong with Banking and What to Do about It*, New York 2013; Miles, D./Yang, J./Marcheggiano, G., *Optimal Bank Capital*, Bank of England Discussion Paper No. 31: revised and expanded version, April 2011.

guarantee and constitutes a competitive advantage for the banks. Therefore, it must be welcomed that the Basel Committee has announced a review of its capital recommendations with a view to possibly tightening them further.

**1579.** In that regard, the Monopolies Commission is well aware that already the current capital requirements were controversial as concerns possible repercussions of an increase at the provision of loans. For example, it was pointed out already in relation to the Basel III recommendations, standing behind the requirements, that the banks would need an additional EUR 256 billion in Europe alone to meet the new capital requirements.<sup>391</sup> For the European legislative projects CRD III and CRD IV, the European Commission itself assumed that they would lead to an increase of capital requirements of 24.5% for large banks and of still 4.1% for small banks.<sup>392</sup> At the beginning of its Basel III monitoring per the cut-off date 30 June 2011, the Deutsche Bundesbank determined that 34 German banks would need capital in the amount of EUR 88.4 billion if Basel III were implemented completely (taking into account the capital conservation buffer and the buffer for systemically relevant banks, and after the phase-out of the transition rules), the bulk of EUR 84.3 billion accruing to nine large, internationally active institutions.<sup>393</sup>

**1580.** In view of this situation, industry representatives warned of the risk of credit contraction if the proposed capital rules were introduced without modification. Capital would be expensive for the banks, which meant that higher capital requirements would force them to reduce their loan provision activities. Banks mainly active on the capital markets would be forced, in the alternative, to switch to riskier business activities in order to generate profits that could be used to attract investors for additional capital. It is true that banks can meet higher capital requirements through the reduction or redeployment of risk assets. In the context of the implementation of Basel III, also German banks made use of this option. In that context, however, no major credit contraction took place, but rather a reduction of the average risk of risk-weighted assets since banks preferred to reduce the assets to which regulation attributed a higher risk weight (e.g., ABS).<sup>394</sup> To avoid credit contraction, it is moreover decisive that sufficiently generous transition periods exist, as have been provided for in the context of the implementation of Basel III in the EU.

**1581.** The other arguments raised against the introduction of higher capital requirements are not convincing either. Those who make these arguments forget to provide reasons why equity is “more expensive” in the banks’ view than outside capital. Factors such as the tax preference for outside capital, its partial insurance within the framework of deposit insurance, and not least the implicit guarantees discussed in this Report are crucial to make creditors make capital available to banks at lower interest. Higher capital provisions reduce the risk of bankruptcy, meaning that equity can be attracted against lower capital returns and that the costs of outside capital are lower as well (lower risk premium).<sup>395</sup> For the banks as such, higher outside financing is cheaper, but its cost is actually borne by other market participants, particularly the taxpayers.

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<sup>391</sup> Cf. Demary, M., Ein Vorschlag für eine europäische Bankenunion ohne automatische Vermögenshaftung von Bankenverlusten, [2013] IW policy paper No. 16, p. 7. However, the figures of such estimates oscillate considerably.

<sup>392</sup> European Commission, Proposal for a Regulation of the European Parliament and the Council on prudential requirements for credit institutions and investment firms, COM(2011) 452 final, 20 July 2011, Section 2.2.3 (p. 7); without this being contained in the German text of the Proposal, COM(2011) 453 final.

<sup>393</sup> Cf. Deutsche Bundesbank, Ergebnisse des Basel III-Monitoring für deutsche Institute. Stichtag 30. Juni 2011, April 2012.

<sup>394</sup> Cf. Deutsche Bundesbank, Ergebnisse des Basel III-Monitoring für deutsche Institute. Stichtag 31. December 2012, September 2013.

<sup>395</sup> See, particularly, Admati, A./Hellwig, M., The Bankers’ New Clothes: What’s Wrong with Banking and What to Do about It, *supra*, pp. 107-112.

**1582.** Furthermore, it must be emphasised that potentially increasing credit costs due to increased capital requirements should not be viewed in isolation. Rather, it is necessary from a macroeconomic perspective to conduct a cost-benefit analysis that also takes into account the advantages of higher capital requirements, particularly the increased systemic stability and, thus, the lower likelihood of financial and economic crises. In a relevant study, the Basel Committee arrives at the conclusion that higher capital requirements overall have a positive net effect. If the capital ratio is set at 10-11% and banks observe a Net Stable Funding Ratio of one, as is foreseen within the framework of Basel III<sup>396</sup>, the long-term economic growth is higher by 1.75 to 1.85% as compared with the historical average ratio of 7%. The study sets the capital ratio claimed to be optimal at 13%, with economic growth increased by 1.9%.<sup>397</sup> The results of further studies show as well that the increases within the context of Basel III constitute principally a step in the right direction, though the results differ sometimes considerably with regard to the level of the optimal capital ratio.<sup>398</sup>

**1583.** In particular with regard to banks benefiting from an implicit guarantee, another factor also militates in favour of high capital ratios. High capital ratios limit the possibilities for the respective banks to leverage the capital as before. Leverage does not result in systemic risk in the sense that it creates additional channels for contagion that can transmit systemic effects. That said, it increases the threat to the bank's very existence.<sup>399</sup> Thus, the implicit guarantee to the benefit of the bank is still increased. Therefore, limitations on the ability of systemically relevant banks to leverage capital should come along with a reduction of their implicit guarantees.

**1584.** In that context, it must be regretted that the Federal Government in the European Council expressly objected to the proposal to allow Member States to at least tighten the capital requirements further on the national level. That tightening in some Member States would presumably have affected all banks in the same way, or predominantly the banks that are considered to be systemically relevant and whose stability is consequently viewed by the other market participants as crucial. In any event, this would have strengthened the capital-based risk buffers in the relevant Member States. As a first step, this would have increased the attractiveness of the banks in that Member State for investors, and as a second step, it could have led to a "race to the top" between the Member States with regard to capital regulation. This would have shifted the focus of competition in the financial markets away from the use of subsidies (implicit guarantees) and to the direction of creating risk-adequate market conditions. It cannot simply be contended that prior to the financial crisis, a race rather to the bottom could be seen directed towards low capital ratios. The UK and Sweden, for example, opposed the meanwhile introduced rules at first because they considered the envisaged capital requirements to be insufficient and sought to retain the option to set stricter (!) requirements. Germany and France, however, opposed this position based on the "principle of maximum harmonisation", according to which the capital rules should be as homogeneous as possible across Europe, such that distortions of competition could be avoided.<sup>400</sup> That being said, the German government agreed to a compromise after the proposed rules had been supplemented by a rule based on which silent participations would count towards capital. This rule is mainly to the benefit of the member institutions of the savings bank group and the cooperative group.

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<sup>396</sup> Regarding the assessment of the liquidity rules, see paras. 1606 ff.

<sup>397</sup> Cf. Basel Committee on Banking Supervision, *An assessment of the long-term economic impact of stronger capital and liquidity requirements*, August 2010, p. 29.

<sup>398</sup> See, e.g., Miles, D./Yang, J./Marcheggiano, G., *Optimal Bank Capital*, supra, who find an optimal capital ratio of between 16 and 20%.

<sup>399</sup> Thus, also the return on equity (= earnings in relation to the used equity) is a questionable success measure; cf. Hellwig, in: Hellwig/Höfling/Zimmer, *Gutachten E/F/G zum 68. Deutschen Juristentag*, supra, pp. E 40-41.

<sup>400</sup> See the summary of the Council debate of 30 November 2011 as to Doc. 2011/0202(COD); related: Committee on Economic and Monetary Affairs, *Report of 12 June 2012 for the Plenary for the first and only Reading*.

**1585.** The Monopolies Commission would have favoured regulatory competition in the direction of more risk-adequate (considering previous regulation, i.e., stricter) capital rules. It takes a sceptical view towards the principle of maximum harmonisation, as it was applied in the relevant EU legislation. The principle mainly protects banks that are inadequately capitalised, and it cements the competitive advantages remaining for banks with an implicit guarantee under the new EU rules. In this context, a fundamental problem of Basel III implementation in the EU becomes apparent, i.e., that the recommendations of the Basel Committee are not merely regarded as minimum standards, but in parallel as some sort of maximum limit. A rare exception is found in the systemic risk buffer – which was a result, among others, of pressure of the aforementioned Member States. Also in this regard, however, the EU has implemented barriers that hinder Member States from imposing stricter requirements on their banks.

**1586.** However, not only the defined capital ratios call for a critical examination of the existing capital rules. From a competition policy perspective, the complexity of the new rules also gives rise to concerns. The definition of the instruments accepted as capital assets, and the definitions of and percentages for risk positions reach a level of complexity never seen before, which entails a substantial risk of errors and misinterpretations. This risk exists with regard to the statutory rules as such and also their application.

**1587.** The European rules define the capital assets sometimes differently from the Basel Committee's recommendations. It must be noted as a positive element that the deviations have at least been reduced since the financial crisis. Nonetheless, it is not without risk that already Tier 1 capital is defined differently from the Basel Committee's recommendations.<sup>401</sup> This may impair the function of capital as a loss buffer and competitive disadvantages may ensue for European banks if they have to pay higher risk premiums on the financial markets.<sup>402</sup> In respect of hybrid financial instruments, such as silent participations, Germany had pressed for their recognition as common equity Tier 1 capital. This has raised criticism as also silent participations can be a channel of systemic risk. Regarding the adequate treatment of hybrid instruments, however, uncertainty continues to exist, and the Monopolies Commission consequently does not take a position on this issue.<sup>403</sup> That said, it takes a critical view in so far as State aid instruments are recognised as equity for a generous transition period (until 2017). This provision prolongs the implicit guarantees for the banks receiving State aid.

**1588.** The definitions of risk positions and the percentage rates for their use in the calculation of capital deviate sometimes from the Basel Committee's recommendations as well. These deviations are usually politically motivated and may be accepted in so far as they benefit particularly smaller banks (e.g., the rules on the capital needed for SME banking). In some cases, however, the rules provide for risk valuations leading to rather little capital with regard to certain risks if the risks are especially typical of banks considered to be systemically relevant (e.g., private equity or hedge fund investments). Still, the new rules continue to be silent as regards the recognition of systemic risks due to interconnections ("too connected to fail"). Likewise, they do not cover risks ensuing from the pursuance of parallel business models ("too many to fail").<sup>404</sup>

**1589.** The risk weights are problematic as they not only distort competition between banks, but moreover can go along with stability risks that are difficult to assess. For example, the risk weight for

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<sup>401</sup> Cf. Basel Committee on Banking Supervision, *Basel III Regulatory Consistency Assessment (Level 2)*, Preliminary Report: European Union, October 2012, p. 12. Such deviations can have as their result that the Basel Committee's recommendations are not implemented completely.

<sup>402</sup> Cf. Demary, M./Schuster, T., *Die Neuordnung der Finanzmärkte. Stand der Finanzmarktregulierung fünf Jahre nach der Lehman-Pleite*, supra, p. 64.

<sup>403</sup> See, e.g., Article 29(4) Subsec. 2 of Regulation 575/2013 (as to silent interest).

<sup>404</sup> Also regarding large exposures; see German Banking Industry Committee (Deutsche Kreditwirtschaft), *Opinion of 4 September 2013*, and press release of 11 August 2013 on the regulation of large exposures and relates press articles.

sovereign bonds of EU Member States continues to be 0% under the standard approach irrespective of their rating if the bonds are issued in the country's currency and are refinanced in that currency.<sup>405</sup> This currently only means that southern European sovereign bonds benefit from preferential treatment in competition with other bonds and credit investments.<sup>406</sup> Should, however, the ECB raise interest rates again – for instance, because of expected inflation – this could drive the prices for sovereign bonds away down, leading to perilous instability.<sup>407</sup>

**1590.** In particular larger banks also benefit from the option of using the internal-ratings-based approach for the weighting of risks. This allows them a more favourable appraisal of their risk profile as compared with other banks.<sup>408</sup> Against this backdrop, the Monopolies Commission welcomes the Basel Committee's proposal that all banks should calculate risk to a certain extent also based on the standard approach and report their capital on that basis.<sup>409</sup> The ECB could likewise take this approach into account when conducting its asset quality review.

**1591.** All in all, it must be stated that the European capital rules still appear too lenient to adequately reflect the relevant risks. To the extent that the requirements of capital regulation do not capture risks, or do not capture them completely, this militates again for still higher capital rules. The Monopolies Commission emphasises moreover that the present requirements may lead to erroneous assumptions in the market and, thus, may provoke further distortions of competition due to their complexity and the lack of outside transparency. It advocates no longer following the path to still more complex capital rules. To the contrary, regulation should be simplified to create as transparent market conditions as possible. The Basel Committee envisions standardising the banks' risk models according to the criteria risk adequacy, simplicity, and reliability, which would be a first step in this direction.<sup>410</sup>

– *Leverage ratio* –

**1592.** The risk-based capital ratios are complemented through the introduction of a leverage ratio. This ratio will be a simple, non-risk-based figure that is supposed to contribute to limiting the absolute indebtedness of the banking industry, and to prevent destabilising deleveraging. It is defined as the ratio of common equity and the – principally – non-risk-weighted total assets (on and off balance).<sup>411</sup> The following formula applies:<sup>412</sup>

$$\frac{\text{Common Equity}}{\text{Non – Risk – weighted total assets}}$$

The leverage ratio is contemplated principally as a backstop, meaning that the risk-based capital rules will continue to be the predominant form of capital regulation. Therefore, banks will also face limitations in the use of outside capital (leverage) only where leverage would be admissible if they complied with the risk-based capital ratio in isolation, but not with the leverage ratio. Pursuant to the

<sup>405</sup> Article 114(4) of Regulation 575/2013. For the treatment under the IRB approach, see Articles 153, 166 of Regulation 575/2013.

<sup>406</sup> See Section 5.6.2 below.

<sup>407</sup> Brunnermeier, as quoted in: Rexer, Die Erpresser, Süddeutsche Zeitung, 8 July 2013 (denoting the pressure potential of the banks as “financial dominance” (“*Finanzdominanz*”) in this context.

<sup>408</sup> Cf. Articles 142 ff. of Regulation 575/2013 (so-called IRB approach).

<sup>409</sup> Basel Committee on Banking Supervision, Fundamental Review of the Trading Book: A Revised Market Risk Framework, Consultative Document, October 2013.

<sup>410</sup> Cf. Basel Committee on Banking Supervision, Discussion paper. The regulatory framework: balancing risk sensitivity, simplicity and comparability, July 2013.

<sup>411</sup> Article 429 of Regulation 575/2013.

<sup>412</sup> Contrary to what the formula suggests, sometimes also rather low conversion factors exist for structures outside the balance, meaning that many out-of-balance operations are only integrated in a reduced form in the denominator of the leverage ratio. Thus, the leverage ratio is more positive for many banks than would be the case if the actual total assets were taken into account.

Basel Committee's recommendations, a leverage ratio of 3% is supposed to apply for a transitional period, meaning a limitation of the total balance sheet to 33.3 times the common equity. The EU has not introduced the leverage ratio as a binding rule yet. Rather, its introduction is only foreseen based on a collection of experience with the instrument until 2018.<sup>413</sup> Regulators are moreover discussing the setting of different leverage ratios dependent on the business model, the risk profile, and the overall size of the banks. Nevertheless, the market heeds the leverage ratio already to a significant extent.

**1593.** The main advantages of the leverage ratio are that it is relatively easy to calculate and that it limits the absolute leverage and the risks associated with it for the banking industry. On the one hand, potential shortcomings of risk-based capital regulation can be avoided because the leverage ratio is not risk-weighted. This is particularly relevant as to wrong specifications of internal models and incorrect external ratings. On the other hand, there is a reduced risk of uncoordinated deleveraging, as it happened during the most recent financial crisis. This lowers the pro-cyclicality of the financial system.

**1594.** A lack of risk-sensitivity and, thus, incentives to accept more risk to achieve higher earnings are the disadvantage on the other side of the equation. Incentives to substitute risky operations for less risky ones exist as long as the bank's capital suffices to cover the expected losses of the risky operations. That being said, the disadvantage of a higher acceptance of risk would exist in particular if the leverage ratio were established as the only form of capital regulation. Where it complements the still existing risk-based capital rules, however, the substitution of risky for less risky business operations is confined to narrow limits as higher risk would have to be backed with higher capital. Hence, not only is the leverage ratio a backstop to prevent excessive leverage, but the risk-based capital regulation also protects the banks from accepting too much risk. Nevertheless, it could be reasonable to set different leverage ratios for different business models. Particularly regional banks with a business model with rather low risks could be subject to lower leverage ratios than systemically relevant institutions.

**1595.** The effects of the leverage ratio of the banks' indebtedness will depend substantially on the ratio's final definition and its amount. From a competition policy perspective, it is material in this context that the leverage ratio is defined uniformly on the international level and that, for instance, different accounting standards do not affect the reported ratios. In January 2014, the Basel Committee submitted a revised definition of the leverage ratio, which addresses notably the differences in the reporting of derivative accounts and, thus, contributes to more homogeneous competitive conditions.<sup>414</sup> The Monopolies Commission welcomes this revised definition on principle. Nevertheless, it criticises the fact that the rules on derivatives account settlement lower the common denominator of the leverage rule, meaning that the leverage ratio is much more positive for many banks than without this settlement option. This shows how important the final calibration of the leverage ratio will be.<sup>415</sup>

**1596.** In this context, one may also raise the question of which amount should be reserved for the leverage ratio. An excessively lenient leverage ratio would not be effective in preventing excessive risk accumulation and potentially destabilising deleveraging, but an excessively tight ratio could constrain loan provision, at least temporarily. Taking the leverage ratio of 3% contemplated so far,

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<sup>413</sup> Cf. Recital 94 of Regulation 575/2013.

<sup>414</sup> Basel Committee on Banking Supervision, *Basel III: Basel III leverage ratio framework and disclosure requirements*, January 2014.

<sup>415</sup> Another problem can follow from the fact that derivative exposures are not reported anymore where "netting" is possible, meaning that the amount of derivative exposures is not apparent to the outside (also: to supervisors) anymore; cf. Hoenig, T. M., speech at the National Association for Business Economics, 30th Annual Economic Policy Conference, Arlington (VA), 24 February 2014, <http://www.fdic.gov/news/news/speeches/spfeb2414.pdf>; accessed: 24 June 2014.

however, there appears to be a low risk of credit contraction if business yielding low profits is in fact reduced. Already today, many institutions mostly active in the traditional credits and loan business comply with this leverage ratio. For example, a current Bundesbank report shows that 38 smaller banks in the sample have a mean leverage ratio of 4.3% along with a capital need of only EUR 4.2 billion. The eight large banks in the sample, however, fall behind with a mean leverage ratio of only 2.2% and a capital need of EUR 37 billion.<sup>416</sup> Against the backdrop of these figures, the risk of credit contraction should exist only if the leverage ratio were set much higher or if it were introduced abruptly.

**1597.** The EU's willingness to examine setting a binding leverage ratio must be welcomed overall. The Monopolies Commission welcomes in particular the Basel Committee's efforts to develop uniform calculation methods based on market consultations in order to avoid, for example, distortions of competition due to different accounting standards. That said, the Basel Committee's recommendation of a leverage ratio of 3% appears overly generous towards the banks, particularly on the basis of the definition revised in January 2014, which tends to lead to higher leverage ratios. A leverage ratio of 3% is also more lenient than what many experts are calling for. For example, the Council of Economic Experts advocates a leverage ratio of 5% based on the original Basel III criteria.<sup>417</sup> The Scientific Advisory Council has recommended a non-risk-weighted capital ratio of 10% without this ratio, however, accommodating off-balance positions.<sup>418</sup> Other financial market experts recommend a leverage ratio of 20 to 30%.<sup>419</sup> Even though the recommendations cannot be compared directly as they define the leverage ratio differently, there is a more or less uniform call for a leverage ratio above 3%. The Monopolies Commission joins the voices calling for a tighter leverage ratio. It also emphasises that the leverage ratio should be introduced as a definite element of the minimum prudential capital requirements (1<sup>st</sup> Pillar).

– *Bail-in bonds (Contingent Convertibles or CoCos)* –

**1598.** Another newly introduced instrument consists in the aforementioned bail-in bonds, which render other instruments so far recognised as Tier 1 capital superfluous and supplant them.<sup>420</sup> Bail-in bonds are hybrid instruments as they securitise outside capital that meets certain conditions and is converted into equity only in the event of a trigger event (debt equity swap). Unlike other convertible bonds, this conversion takes place without any option to choose. The newly introduced bail-in bonds provide the possibility to banks – as mentioned above – to obtain common equity where this cannot happen on the market due to a crisis and risk could otherwise only be reduced by dint of fire sales. Thus, they are countercyclical capital instruments that functionally complement the countercyclical buffer. In the reporting period, banks have already issued bail-in bonds to a considerable extent.<sup>421</sup>

**1599.** Introducing bail-in bonds is a step to be welcomed for the reduction of systemic risk – and, thus, the implicit guarantees existing for systemically relevant banks. That said, the statutory design of the instrument in the EU must be greeted with reservation. It must be considered, in particular, that other

<sup>416</sup> These ratios are based on the definition of the leverage ratio in the consultation paper of June 2013 and should be higher following the redefinition of January 2014. Cf. Deutsche Bundesbank, Ergebnisse des Basel III Monitoring für deutsche Institute. Stichtag 30. Juni 2013, March 2014.

<sup>417</sup> Cf. Council of Economic Experts, Annual Economic Report 2011/2012, supra, para. 294.

<sup>418</sup> Cf. Scientific Advisory Council at the Ministry of Economic Affairs, Reform von Bankenregulierung und Bankenaufsicht nach der Finanzkrise, supra.

<sup>419</sup> Cf., e.g., Admati, A./Hellwig, M., The Bankers' New Clothes: What's Wrong with Banking and What to Do about It, supra, pp. 179, 182.

<sup>420</sup> Articles 51 ff. of Regulation 575/2013. Regarding this instrument, see already previously, e.g., Calomiris, C.W./Herring, R.J., Why and How to Design a Contingent Convertible Debt Requirement (2011), <http://fic.wharton.upenn.edu/fic/papers/11/11-41.pdf>; accessed: 24. June 2014.

<sup>421</sup> Cf. Osman, Y., Impfstoff gegen Finanzkrisen, Handelsblatt, 11 April 2014 (2013: USD 14 billion; Januar-April 2014: > USD 20 billion). According to the article, however, bonds with temporary write-downs are increasingly popular instead of convertible bonds.

banks may hold these bail-in bonds. In this case, the bonds would not fulfil one of the core functions of this category of bonds, i.e., to allocate the banking risks to investors outside the banking sector. Thus, if a bank were to default, the authorities could not order conversion without having to fear that the risks spread to other banks.<sup>422</sup> Thus, bail-in bonds contribute little to reducing systemic risk and implicit guarantees. It will be necessary to monitor to what extent banks will invest in the bail-in bonds of other banks. If necessary, the EU rules should be supplemented with a limit on the bank holdings of bail-in bonds.

**1600.** In addition, it would have been preferable to raise the common equity Tier 1 ratio to 6% and to prescribe bail-in bonds only as an additional instrument that does not count towards the total capital ratio. This would have allowed the bail-in bonds to fully meet the function of an additional buffer applying already if the total capital decreases below the statutory minimum. Under the current rules, the buffer function is only relevant in case the core capital ratio drops. Thus, in the case of a trigger event, only a shift takes place from the additional capital to the common equity capital, but no strengthening of the total capital.

A bail-in bond prescribed for a drop in the total capital ratio could be designed with regard to systemic crises if the existence of a systemic crisis were taken into account beside the drop of the common equity ratio.<sup>423</sup>

– *Limit on large exposures* –

**1601.** In April 2014, the Basel Committee also published a standard for large exposures, which is supposed to apply as of 2019 and which provides for a general limit of 25% of a bank's Tier 1 capital towards a single counterparty or groups of connected counterparties. A stricter limit of 15% of a bank's Tier 1 capital will apply to exposures between banks that have been designated as global systemically important banks (G-SIBs).<sup>424</sup> These limits supplement the authorities' powers in the context of the banking union to limit the amount of interbank liabilities relevant for the bail-in tool.<sup>425</sup> They will apply independent from the rules regarding a possible resolution.

**1602.** The present standard is intended to contribute to the reduction of contagion risk due to connections between banks. The establishment of such exposure limits appears reasonable since the connections between banks can increase systemic risk considerably. However, banks can also acquire an interest in other banks through non-bank stakeholdings. Consequently, the present exposure limits only seem useful as an additional instrument.

### ***Putting the rules into the regulatory context***

**1603.** Regarding the issue of implicit guarantees, the capital requirements established so far must be assessed also in conjunction with the other rules supposed to prevent the use of implicit guarantees. In any event, it must be acknowledged that one will only be able to get close to risk-adequate capital requirements because the risks leading to systemic importance and, thus, to the emergence of implicit guarantees can be associated with any possible bank interactions with other market participants. However, together with general banking regulation, the capital rules should at least exclude that banks can shift the risk from their core business – the provision of loans – to the State and, thus, the taxpayer.

**1604.** The will of the political parties is that current regulation should chiefly ensure that, beside equity holders, only outside investors with investments exceeding EUR 100,000 are fully liable if a

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<sup>422</sup> Cf. Krahen, [2013] BB No. 42, Die Erste Seite.

<sup>423</sup> See Rudolph, [2011] ZHR No. 175, 284, (313).

<sup>424</sup> Cf. Basel Committee on Banking Supervision, Supervisory framework for measuring and controlling large exposures, April 2014.

<sup>425</sup> Article 27(4) SRM Regulation; Article 44(2) last sentence BRRD and above para. 1504.

bank defaults. In contrast, outside investors (depositors) with investments of up to EUR 100,000 should not be liable. This objective can only be achieved without State liability – according to what is said above<sup>426</sup> – if the available capital and the other available funds (from deposit insurance, minimum reserve, etc.) are sufficient to pay the non-liable deposits in the amount of EUR 100,000 to the outside investors in the event of the bank’s default, and to resolve the bank without putting systemic stability at risk. It is questionable, however, whether the present capital requirements are sufficient in that respect. Present regulation is based on an arbitrarily chosen total capital figure defining the entire regulatory capital. The buffers and the leverage ratio are not clearly aligned with the liability cascade either. Given that the existing rules still coincide with fair value accounting, it cannot be ruled out that risks are weighted too leniently with regard to a possible crisis, and that capital will be therefore insufficient.

**1605.** In addition, it must be taken into consideration that, aside from the capital rules, banking rules exist that may vary across Member States. It cannot be ruled out that these rules have an impact on the banks’ “structural” risk profile. For example, it must be assumed that the introduction of a dual banking system could require higher capital provisions for the universal banks’ separated, risky business divisions, taking into account that the banks would no longer be able to cross-subsidise these divisions. It is still unclear, however, whether the current capital rules sufficiently accommodate the remaining leeway for the design of the banking systems in the Member States.

### *Liquidity requirements*

**1606.** The financial crisis has demonstrated that risks for financial stability can emanate not only from insufficient capital, but also from insufficient liquidity. The Basel Committee took this into account already when it published its general principles of liquidity in 2008.<sup>427</sup> When publishing the framework rules of Basel III<sup>428</sup> in 2010, it broadened these principles by means of several standards to monitor liquidity risk and two quantitative minimum standards concerning the provision of liquidity, the minimum liquidity ratio (Liquidity Coverage Ratio) and the structural liquidity ratio (Net Stable Funding Ratio). Both liquidity figures address different time frames.

– Liquidity Coverage Ratio –

**1607.** The minimum liquidity ratio (Liquidity Coverage Ratio – LCR) concretises the liquidity buffer that was introduced in the context of qualitative liquidity principles. It is intended to strengthen the short-term resilience of the banks’ liquidity profile and to ensure that the banks can respond to their short-term payment obligations. To that end, the banks are expected to preserve a sufficient amount of unencumbered highly liquid assets that cover at least the net payment obligations over a period of 30 days under the conditions of a liquidity stress scenario. The following formula applies:

$$LCR = \frac{\text{Stock of highly liquid assets}}{\text{Total cash outflows} - \text{Total cash inflows (max. 75 percent)}} \geq 1$$

**1608.** The numerator of the LCR is composed of an institution’s total volume of highly liquid assets. Assets are generally accepted as highly liquid if they can be sold with low value losses, if any, on the market even in stress situations. Originally, a distinction was made between highly liquid Level-1 assets (e.g., cash, claims towards the central bank, sovereign bonds) and highly liquid Level-2 assets (e.g., creditable company debt certificates and covered bonds with a minimum rating of AA-). After a revision by the Basel Committee, the category of Level-2B assets (e.g., creditable RMBS, company

<sup>426</sup> See Sections 3.6.1.1 and 3.6.1.3 above.

<sup>427</sup> Cf. Basel Committee on Banking Supervision, Principles for Sound Liquidity Risk Management and Supervision, September 2008.

<sup>428</sup> Cf. Basel Committee on Banking Supervision, Basel III: Basel III: International framework for liquidity risk measurement, standards and monitoring, December 2010.

debt certificates with a minimum rating of BBB-, creditable ordinary stock) has been added, though without the national authorities being required to recognise these assets.<sup>429</sup> Regulatory caps apply to the recognition of Level-2 assets. The total of highly liquid assets may consist of up to 40% of Level-2 assets, at least 15% of which may be Level-2B assets. In addition, the assets are only credited with a discount on their market value. The discount on the market value of Level-2A assets is 15%, and the one on the value of Level-2B assets is 25% or 50%.

**1609.** The LCR denominator is derived from the proportion of the payments made to the payments received, though the latter are only recognised to up to 75% of the total expected payments made. The payments made are derived from the unsettled balances of the different categories of liabilities and off-balance engagements, which are each multiplied with run-off factors oriented at the probability that these factors will be used. The expected payments received are derived from the unsettled balances of the different categories of contractual claims that are each multiplied with a factor reflecting the expected probability that the payment will indeed be received. In the context of the aforementioned Basel Committee revision of the LCR, the original amount of some run-off factors for payments made was reduced. For example, deposits secured through deposit insurance may be taken into account with a run-off factor of only 3% in lieu of 5% in the future. The result is a reduction of net payments received, meaning that banks must reserve less highly liquid assets in order to meet the LCR.

**1610.** In the EU, it is planned to gradually implement the LCR until 2019.<sup>430</sup> As from 1 January 2015, an LCR of 60% will apply. This LCR will increase by 10% every year, meaning that an LCR of 100% must be met as of 2019. In times of stress, it is permitted to fall below these minimum requirements in order to secure financial solvency.

The LCR has only been defined vaguely so far and is essentially still subject to implementation by way of a delegated act to be passed by the European Commission until 30 June 2014. Up to then, the requirements for the design of the LCR should be concretised. In the meantime, EBA has presented a recommendation for the definition of highly liquid assets to the European Commission. According to it, sovereign bonds, in particular, should be recognised as Level-1 assets. Various forms of covered bonds, RMBS, company debt certificates, ordinary shares as well as securities issued by the State should be classified as Level-2 assets to which different discounts apply.<sup>431</sup>

**1611.** The (still) vague definition of the LCR in the Regulation differs from the Basel Committee's recommendations notably in regard of two elements. On the one hand, the Regulation foresees a slightly accelerated schedule for the introduction of the LCR in the EU. Already in 2018, the LCR is supposed to apply 100% although the European Commission is entitled to adapt this time frame to the one of the Basel Committee.<sup>432</sup> On the other hand, the EU limits the recognised highly liquid assets further than the Basel committee and focuses mainly on sovereign bonds. It explicitly does not recognise the assets of investment firms, insurance undertakings or (mixed) financial holding companies.<sup>433</sup> This has as its result that sovereign bonds gain relatively more importance in the calculation of the LCR. Apart from that, the Regulation does not comprise an exclusive list of the recognised highly liquid assets. The EBA's above-mentioned recommendations, in contrast, limit the divergence from the Basel Committee's recommendations and must be welcomed in that respect. The European Commission's final definition of the LCR is still outstanding.

<sup>429</sup> Cf. Basel Committee on Banking Supervision, *Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools*, January 2013.

<sup>430</sup> Articles 411 ff. of Regulation 575/2013.

<sup>431</sup> Cf. EBA, *Report on appropriate uniform definitions of extremely high quality liquid assets (extremely HQLA) and high quality liquid assets (HQLA) and on operational requirements for liquid assets under Article 509(3) and (5) CRR*, 20 December 2013.

<sup>432</sup> Article 460 and Article 461(2) of Regulation 575/2013.

<sup>433</sup> Article 416 of Regulation 575/2013.

**1612.** The introduction of a short-term liquidity figure with a view to creating a liquidity buffer must generally be welcomed from a competition perspective, in so far as this figure will contribute to strengthening the resilience of credit institutions and, thus, to lowering or avoiding the systemic risks potentially following from the insolvency of the institution. The strengthening of the resilience of systemically relevant institutions, in particular, lowers the likelihood that State rescue measures will be required to secure systemic stability, and so lowers the value of implicit guarantees.

**1613.** Nevertheless, the Monopolies Commission takes a critical stance towards the LCR in its current form. It appears appropriate, in principle, to introduce this instrument gradually as this allows the countering of potential shortages in highly liquid assets, though a large number of German institutions already comply with the LCR.<sup>434</sup> However, material criticism is from a competition perspective related to the calculation methodology and the grading of assets with regard to their liquidity – the latter, in particular, in the EU Regulation.

**1614.** Further criticism is levelled at the distinction between Level-1 and Level-2 assets in conjunction with the introduction of a regulatory cap of 40% for the latter. Since Level-1 assets basically consist of sovereign bonds, banks are compelled as a matter of fact to invest in these bonds and to retain a minimum reserve of sovereign bonds. In the EU Regulation, this effect is reinforced further through the still stricter limitations on the securities accepted as highly liquid assets. In addition, no exposure limit for banks vis-à-vis public debtors exists in the EU – in contrast to the limits on other large credit exposures. Hence, both the cap on Level-2 assets and the definition of highly liquid assets result in another<sup>435</sup> advantage for bonds issued by the State, which is questionable in terms of regulatory policy. This advantage results, first, in a direct distortion of competition to the detriment of other debtors and, second, in additional connectedness between the banks and the State, instead of a decrease of such connections. Also, if the EBA's recommendations were implemented, the questionable caps would still apply.

**1615.** Only partially, these concerns are alleviated inasmuch as the number of creditable Level-2 assets is increased through the introduction of the category of Level-2b assets and the reduction of run-off factors. It is true that the measures generally allow for a more refined differentiation of Level-2 assets, and that they may hence reduce the amount of sovereign bonds in the overall portfolio of highly liquid assets. However, this effect is restrained through the continued existence of the 40% cap on the Level-2 assets, which means that, overall, no major change takes place in relation to sovereign bonds.

**1616.** Apart from that, increasing the number of creditable Level-2 assets is not without risk from stability and competition points of view. As a matter of fact, introducing the category of Level-2b assets constitutes not only a revision, but partially also the dilution of the original definition of the LCR. The Monopolies Commission highlights in this context that it must be ensured that the LCR is designed in a way that it can fulfil its original objective to counter liquidity risks. Otherwise, in times of crisis, liquidity shortages could arise again that could require the State to rescue banks in distress that are considered to be systemically relevant, which would prolong the implicit guarantees to their benefit. In that respect, the Monopolies Commission welcomes the works of the Basel Committee and of the EBA to investigate the effects of the individual rules more closely.

**1617.** Finally, it must be noted that the introduction of the LCR can also have unintended consequences. An example would be the redeployment of assets to highly liquid risk positions, which might have negative effects on the provision of loans. In addition, highly liquid assets yield lower interest, which could in turn impair the banks' earnings situation and thereby counteract the efforts to strengthen their capital base. This applies all the more as competition for such assets, for example,

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<sup>434</sup> Cf. Deutsche Bundesbank, Ergebnisse des Basel III Monitoring für deutsche Institute. Stichtag 30. Juni 2013, March 2014.

<sup>435</sup> See para. 1589 above (as to the capital rules).

customer deposits, may be expected to increase.<sup>436</sup> The gradual implementation of the LCR largely addresses these concerns. Nonetheless, the authorities should monitor the potential consequences of its introduction.

**1618.** All in all, the Monopolies Commission recommends the use of the delegated European Commission act to align the preliminary EU rules with the final recommendations of the Basel Committee in order to avoid distortions of international competition. In this context, the revision of the list of highly liquid assets creditable in the EU should take priority. To abolish the preference for sovereign bonds, it would also be necessary to set an exposure limit for banks towards public debtors. This exposure limit should be in line with the general large exposure limit, meaning that it should not exceed 25% of the creditable capital.<sup>437</sup> In addition, taking into account the works of the Basel Committee, the Monopolies Commission encourages the abolition or at least raising the regulatorily doubtful 40% cap for Level-2 assets. Instead, the discounts on assets with different liquidity and the weighting factors should – if necessary – be modified in an adequate manner.

– *Net Stable Funding Ratio* –

**1619.** The structural liquidity ratio (Net Stable Funding Ratio – NSFR) is supposed to strengthen the banks' resilience through enhancing their medium- to long-term funding. In comparison with the LCR, it targets a longer time period of one year. The objective is to ensure that the assets and liabilities have a robust maturity structure, by imposing the necessity to refinance capital tied up long-term with longer dated funds than to date. This is to limit the excessive reliance on short-dated financial instruments and to achieve a better evaluation of the liquidity risk of on- and off-balance positions. The Basel Committee defines the NSFR as the ratio of the amounts that are actually available and required, respectively, to ensure stable funding. The NSFR may not fall below a value of 1% and 100% respectively and should be bindingly introduced as of 2018 according to the Basel Committee. The following formula applies:

$$NSFR = \frac{\text{Available amount of stable funding}}{\text{Required amount of stable funding}} \geq 1$$

**1620.** The entire amount of the available stable refinancing is calculated based on factors addressing the stability of the refinancing sources, for example, maturity, the type of refinancing, and the counterparty.<sup>438</sup> On this basis, the individual capital instruments and liabilities are multiplied with a so-called ASF factor lying between 0% and 100%. For regulatory capital, for instance, an ASF factor of 100% applies, for operational deposits only an ASF factor of 50%. The entire amount of available stable funding is the sum of the weighted amounts. The required stable funding is derived from the liquidity risk profile of the individual assets and a bank's off-balance positions. These are multiplied with a so-called RSF factor lying again between 0% and 100%. An RSF factor of 0% applies, for example, to central bank deposits, one of 50% to the above-mentioned Level-2B assets of the LCR. The sum of the weighted amounts equals the total amount of required stable funding.

**1621.** In the European Union, the NSFR will at first not be introduced as a binding liquidity figure. In particular, the EU does not take over the precise definition used by the Basel Committee. Instead, credit institutions will only have to ensure that “long-term obligations are adequately met with a diversity of stable funding instruments”.<sup>439</sup> The European Commission will have the mandate, if appropriate, to submit a legislative proposal on how to ensure that credit institutions use stable sources

<sup>436</sup> Cf. German Banking Industry Committee, Positionspapier zur Liquidity Coverage Ratio (LCR) für das survey lcr-lr-hearing am 10. März 2014.

<sup>437</sup> Article 395(1) of Regulation 575/2013.

<sup>438</sup> As to the following, cf. Basel Committee on Banking Supervision, Basel III: The Net Stable Funding Ratio, January 2014.

<sup>439</sup> Article 413 of Regulation 575/2013.

of funding.<sup>440</sup> Before that, EBA will report to the European Commission by 31 December 2015 on the necessity and the impact of stable funding requirements, if they are introduced. In addition, EBA will submit to the European Commission appropriate methods to determine the amount of stable funding and appropriate definitions to calculate these requirements.

**1622.** The Monopolies Commission is principally open towards the introduction of an NSFR. It is by no means certain that limitations on maturity transformation will have an efficiency-enhancing effect. In addition, limiting maturity transformation can lower the interest margin and, thus, the earnings situation of institutions that are particularly active in this field, which in turn can make it more difficult for these institutions to strengthen their capital base. In particular in times of crisis, however, the better maturity match should contribute to the stability of the financial system and reduce the likelihood that banks have to make use of the implicit guarantees.

In contrast, the divergence and, at this point, vagueness of the definition of the NSFR in the EU must be criticised. To avoid distortions of competition on the international level, it is of crucial importance to avoid a special EU approach. In that regard, the Monopolies Commission argues in favour of an NSFR that is in line with the Basel Committee's recommendations. The transitional period until 2018 should be used to identify potential unintended side-effects of the NSFR. In that respect, the work of EBA must be welcomed. It is, however, important that its results influence the Basel Committee's final definition and do not simply lead to a divergent EU definition.

**1623.** The Monopolies Commission finally emphasises that the introduction of an NSFR will necessarily have an impact on the competition between different financial products, due to the different weighting factors. On the one hand, stronger competition and, thus, higher returns must be expected for savings deposits and long-dated time deposits. On the other hand, one must also reckon on less attractive conditions for bank customers due to the increased issuance of long-dated bank obligations.<sup>441</sup> Some consider in particular the risk of increasing credit cost to be a problem for the German economy. It is argued that in the domestically prevalent system of bank-based company financing, increased credit cost would hit companies particularly hard and would put them at a disadvantage in international competition. This would mean that particularly the traditional banking business would be hit, which exhibited relative stability in the financial crisis.

**1624.** This argument can be rebutted as also German companies can principally resort to capital-market based financing although such financing is still underdeveloped on the domestic market. The NSFR may lead to shifts in that regard, but it does not entail a permanent competitive disadvantage for German companies. In addition, earlier crises demonstrated that the credit business is not safer per se than the capital markets business. The argument made is focused too one-sidedly on passing problems. Potentially rising credit costs should rather be viewed for what they really are: the price for tighter regulation and a more stable banking system. From a microeconomic perspective, this may be disadvantageous for the individual market participant. From a macroeconomic perspective, the higher costs must be balanced against the benefits of a more robust banking system. They are eventually part of the price of releasing the taxpayer from its liability for the banks.

### **3.6.2.2 Further regulatory limitations on trading activities**

**1625.** In connection with the financial crisis, various other legislation was discussed and partially introduced, the following rules appearing to be the most relevant, i.e.: (i) limitations on leveraged finance (through debt/debt derivatives) beyond the capital rules, (ii) limitations on remuneration incentives for speculative business, and (iii) absolute limitations on the overall business as a last resort.

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<sup>440</sup> Article 510 of Regulation 575/2013.

<sup>441</sup> Cf. Hüther, [2013] ZfgK 23 (28).

*Limitations on leveraged finance*

**1626.** Leveraged finance can – broadly – be defined as any method by which the exposure of deposit risk or deposit-like risk is increased whether through borrowing or leverage.<sup>442</sup> Forms of leveraged finance are in the foreground of the rules supplementing capital regulation, including the rules on so-called shadow banking activities.<sup>443</sup>

**1627.** The initial point is the following: Financing can take place using bank loans or money- or capital-market financing. Bank loans are the traditional way for private and corporate customers to obtain outside capital financing. The capital requirements discussed in the section above create an obstacle for banks to leverage their capital to a systemically unacceptable degree in their credit supply. However, in lieu of bank loans, also securities (bonds) and credit derivatives (e.g., CDS)<sup>444</sup> or other derivatives (e.g., standard options, certificates) can be used for financing or refinancing purposes. Structured products (e.g., ABS, CDO) can be used to tranche risk. The risks connected with such instruments, however, are not covered by existing capital regulation in all cases. In addition, their use is accompanied by transaction-related risks.

**1628.** The money and capital market instruments that are relevant in this context are primarily used by larger banks and special institutions, much less so by the savings banks and the cooperative primary institutions. This is reflected in the higher economic margins that particularly the large banks and the *Landesbanken* achieve in the relevant business. In the current market climate defined by (decreasing) State support, low central bank interest and low bank capitalisation, strong incentives exist to engage in this business.<sup>445</sup>

– *Specific risks* –

**1629.** The FSB sees particularly the following sources of risk in the use of money- and capital-market instruments:

- maturity/liquidity transformation,
- imperfect credit risk transfer, and
- leverage.<sup>446</sup>

In the financial crisis, it became apparent that systemic risk results from money and capital market transactions in particular where the supplier and the acquirer of financing pursue primarily speculative objectives (profit objectives), i.e., if they do not seek, or do not do so exclusively, to satisfy concretely existing demand for capital or to hedge risks of loss. If many market participants pursue speculative objectives on the market, this can reinforce market developments and increase the risk of pro-cyclical developments. In these cases, initially excessive leveraging and maturity transformation takes place, which allows higher returns to be achieved, before the market overheats and counterparties drop out. This can lead to panic selling on the relevant market and to a flight out of other still liquid markets

<sup>442</sup> Cf. Article 4(1) lit. v of Directive 2011/61/EU on Alternative Investment Fund Managers (AIFM), OJ L 174, 1 July 2011, p. 1, which defines leverage as methods by which the “exposure of an AIF [is increased,] whether through borrowing of cash or securities, or leverage embedded in derivative positions or by any other means”. German law [also] defines leveraged finance as “Leverage”, § 1(19) No. 25 KAGB.

<sup>443</sup> See Directive 2011/61/EU, OJ L 174, 1 July 2011, p. 1; European Commission, Proposal of 7 February 2011 on European Venture Capital Funds, COM(2011) 860 final; and already previously Joint FSF-CGFS Working Group, The role of valuation and leverage in procyclicality, March 2009.

<sup>444</sup> Cf. § 165 SolvV.

<sup>445</sup> See critically on the market situation: Council of Economic Experts, Annual Economic Report 2013/14, *supra*, para. 371.

<sup>446</sup> Cf. FSB, Shadow Banking: Scoping the Issues, A Background Note of the Financial Stability Board, 12 April 2011, p. 3.

(so-called feedback loops). In addition, risks can backfire unexpectedly if they were transferred incompletely or only seemingly to other market participants.

**1630.** The money market is particularly vulnerable to such developments.<sup>447</sup> The money markets have a large volume worldwide – the average quarterly turnover of the euro money market was roughly EUR 75 trillion (EUR 75,000,000,000,000) in 2012.<sup>448</sup> Money market activities include overnight and time deposits, securities lending and securities repurchasing transactions (repos)<sup>449</sup>, and other (short-dated) transactions involving securities, derivatives, and central bank facilities. According to the FSB's findings so far, the market participants use particularly securities lending and securities repurchasing transactions to create credit-like liabilities. Such credit-like transactions create liquidity, but they come along with the transaction-based risks described above beyond the typical risks of credit supply.<sup>450</sup> Given their high liquidity, a risk exists in the money markets, in particular, that the markets dry out quickly if market confidence shrinks here or in other markets.

**1631.** As central financial intermediaries, the banks are exposed to the aforementioned risks to a particularly large extent. The risks on the money market can threaten their survival the more the business model lacks equilibrium and the more the banks refund their business through the money markets (cf. the notorious case of HRE). This problem has somewhat abated in the meantime due to the new capital and liquidity requirements. Recent regulation has also lowered the risk that flawed risk valuations are used for money and capital market operations. The capital requirements were increased, the requirements for the ratings of financial instruments were tightened. In relation to ABS, the issuer is required to retain risk in the amount of 5% of the nominal value of the securitised claims.<sup>451</sup> That said, banks can be exposed to risk also through their business relations with hedge funds and other market participants that are not subject to banking regulation. Hedge funds, for instance, use short selling, i.e., they sell borrowed financial instruments that they have still to acquire at the time of delivery. Banks act as prime brokers that offer bundles of services to hedge funds, for example, loans and securities settlement services.<sup>452</sup> In short selling transactions, this implies, among others, that they rehypothecate unencumbered assets to enable the hedge funds to hand back the borrowed financial instruments. To the extent that the banks use customer assets for that purpose, this can create stability risks, for instance, if the customers are unsure to what extent the bank has rehypothecated the assets available to it. Further risks of contagion emanate from inadequate valuations of collateral and the connections to other market participants through transaction chains where collateral is being re-used.

**1632.** The risks of money and capital market transactions are more difficult to assess if they relate to financial derivatives instead of plain securities. Derivatives are polymorphic financial products that serve different purposes. According to the Bank for International Settlements (BIS), the nominal total volume just of the outstanding derivatives contracts that were not traded on any exchange (Over-The-Counter – OTC) amounted to more than USD 710 trillion (USD 710,182,000,000,000) at the end of

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<sup>447</sup> The risks referred to in para. 1629 are increased in so far as transactions occur requiring the use of a counterparty and there are transparency and information deficits; see European Commission, Proposal of 29 January 2014 on reporting and transparency of securities financing transactions, COM(2014) 40 final, and Section 3.6.4.2 below.

<sup>448</sup> Cf. ECB, Euro Money Market Survey, November 2013 (on the basis of a panel with 104 credit institutions).

<sup>449</sup> Repos are securities pension transactions based on a short-dated sale and repurchase agreement, and used in interbank trade to provide excess liquidity – or conversely to obtain liquidity.

<sup>450</sup> Cf. FSB, Strengthening Oversight and Regulation of Shadow Banking – Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos, 29 August 2013, pp. 4 ff.

<sup>451</sup> Article 405 of Regulation 575/2013. This provision is complemented by other requirements for ABS which the market participants, however, consider to be too strict; see Sections 3.8.1, 5.6.1 below.

<sup>452</sup> In German law, see § 31 KAGB. In some market segments, the business is shifting to specialised financial service providers with a banking license due to the tightened regulatory requirements.

December 2013.<sup>453</sup> The worldwide Gross Domestic Product (GDP) was nominally roughly USD 73 trillion at this time.<sup>454</sup> When making this comparison, however, it must be noted that the nominal volume does not define the economically relevant volume of the derivatives markets as the nominal amounts do not actually flow between the contracting parties in the case of most derivatives. A more telling indicator consists in the gross market value, which shows the value that derivative contracts would have if they were evened up and settled immediately. At the end of 2013, the gross market value of all OTC derivatives amounted to USD 18.7 trillion, i.e., to less than 3% of the outstanding nominal value.<sup>455</sup> That said, the total volume of derivatives contracts was substantial also in this regard.

**1633.** Derivatives are financial instruments by definition that shift risk independently from the underlying business transactions. The risks do not have to be linked to the business of a counterparty either. This means that different risks can be pooled in a derivative and that risks can thereby be rendered marketable that no one would accept if they were seen in isolation. The flip side of this business is that risks (in isolation or pooled) are transferred into the financial markets and allocated to any participants in the financial markets. Further, the polymorphic structure and the complexity of the instruments and transaction chains create considerable information asymmetries. The complexity of the derivatives business has led to high concentration and to the central market position of individual derivatives traders (the two being related to each other, but having to be considered separately).<sup>456</sup> In the EU market, the 14 to 16 largest derivatives traders on the side of the banks play a prominent role. A larger number of systemically relevant banks and non-banks can be regarded as super-spreaders of systemic risk. This includes primarily the derivatives traders that are bilaterally connected to the largest extent and that all belong to the systemically important banks on the global level (G-SIBs). That said, also several non-banks have large exposures.<sup>457</sup>

**1634.** In the derivatives business, interest derivatives play a particularly prominent role, though their systemic risk potential is considered to be low (especially interest swaps). Interest derivatives currently make up more than 82% of all outstanding OTC derivatives. Following the financial crisis, however, credit default swaps, i.e., CDS, are more in the focus of regulators.<sup>458</sup> At this point, only nearly 3% of all outstanding OTC derivatives are CDS (2007: 8.75%). The systemic importance of CDS should have decreased. According to the findings of the European Systemic Risk Board (ESRB), however, the CDS market is very concentrated as concerns the counterparties.<sup>459</sup> In 2012, the credit default protection was sold by banks in 88% of the cases, the ten most active traders accounting for 73% of the gross sales. The buyers included hedge funds (40%) and asset managers (33%), banks (18%), and other financial service providers.

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<sup>453</sup> BIS, Amounts outstanding of over-the-counter (OTC) derivatives by risk category and instrument, current as of 8 May 2014. OTC trade has so far been more important than the trade through multilateral or exchange platforms, where the platform provider itself provides also the derivatives; cf. European Commission, Decision of 1 February 2012, M.6166, Deutsche Börse/NYSE Euronext, paras. 60, 217 ff.

<sup>454</sup> Cf. World Bank, World Development Indicators, <http://data.worldbank.org/data-catalog/world-development-indicators>; accessed 24 June 2014.

<sup>455</sup> Cf. BIS, Amounts outstanding of over-the-counter (OTC) derivatives by risk category and instrument, current as of 8 May 2014.

<sup>456</sup> Cf. Blundell-Wignall, A./Atkinson, P., Global SIFIs, Derivatives and Financial Stability, [2011] OECD Journal: Financial Market Trends No. 1, pp. 167-200.

<sup>457</sup> See also Section 3.7 below in that context.

<sup>458</sup> Article 2 Abs. 1 lit. c of Regulation 236/2012 on short selling and certain aspects of credit default swaps, OJ L 86, 24 March 2012, p. 1.

<sup>459</sup> Cf. ESRB, Assessing Contagion Risks from the CDS Market, Occasional Paper No. 4, September 2013. The term counterparties is used for the parties to a derivative contract; see Article 2 No. 8, 9 of Regulation 648/2012 on OTC derivatives, central counterparties and trade repositories (EMIR), OJ L 201, 27 July 2012, p. 1.

**1635.** Credit default insurance products can be traded, contrary to other insurance products. Financial market participants can acquire them to hedge existing credit risk as well as to speculate on the materialisation of the risk and to secure a right to performance under that condition. Hence, CDS are an instrument that serves primarily hedging or speculative purposes. The use as a financing tool is closely linked to these two functions.

**1636.** CDS come into play in multifarious transactions. Banks use these instruments traditionally in proprietary trade, for market making, and for hedge transaction. The types of connections through CDS are multifarious as well. Hedge funds and asset managers are potential investors in the securities issued by banks (e.g. convertible bonds, ABS) and use CDS to hedge against market risk. Apart from other banks, however, they are also potential counterparties whenever banks seek to hedge their own CDS. The ESRB estimates that contagion risk in that respect has decreased since 2008. Nevertheless, it still sees the danger that the large volume of the large market participants' gross (and net) exposures in relation to their capital can lead to significant domino-type contagion effects. In that regard, it takes the view that the contagion effects are triggered primarily through direct exposures and non-contractual relations, not through CDS. That said, the polymorphic structure of CDS transactions and the unsatisfactory degree of information constitute a major obstacle for assessing the risks and developing solutions. Besides, market opacity is also another factor contributing to the increase of risks. The relevant risks can threaten the financial system and thereby reinforce the implicit guarantees to the benefit of market participants exposed by means of CDS.

**1637.** Difficulties arise if one attempts to assess the risks of several newer business fields that are mentioned with regard to systemic risk. In that respect, problematic developments are reported particularly from the United States where, however, also German financial service providers (including Deutsche Bank) partake in the relevant business. In the EU, these businesses play a still relatively modest role.

**1638.** In particular, the increase of so-called (leveraged) Covenant-Lite Loans may be accompanied by risks.<sup>460</sup> These are leveraged loans where the capital investor is limited in its credit control because traditional clauses, for example, imposing debt ceilings or with regard to the debt burden level are lacking. Originally, demand for such loans came generally only from creditworthy undertakings, and they were popular particularly in the private equity business. Meanwhile, however also other borrowers use these products. Thus, the market has grown even though the creditworthiness of the borrowers or the quality of the loans has increased in line with that. Potentially systemic risk follows from the securitisation of such loans, among others, through the portfolios of structured instruments (CLOs).<sup>461</sup> Thus, there is a risk that obscure risks will again be accumulated in structured products, as had already been the case in the run-up to the recent financial crisis. At the end of March 2014, the volume of outstanding CLOs in Europe amounted to EUR 197.5 billion.<sup>462</sup>

**1639.** Another business field that has been opened through the initiation of central clearing for OTC derivatives is so-called collateral transformation.<sup>463</sup> For clients wishing to execute derivative transactions through a clearing house, but not having bonds or other collateral of sufficient quality,

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<sup>460</sup> Besides, discussion currently centres mostly on so-called PIK Notes, i.e., notes where interest is not paid in cash, but by new notes (PIK = Payment In Kind). Regarding the sum of the loan, however, these instruments do not constitute leveraged finance, which is why PIK Notes are not dealt with in this context.

<sup>461</sup> CLO = Collateralized Loan Obligation, i.e., a type of ABS where the underlying portfolio ("underlying") is composed of corporate loans (CDO, in contrast: securities).

<sup>462</sup> Cf. AFME, European High Yield & Leveraged Loan Report, 1Q 2014, p. 2, <http://www.afme.eu/WorkArea/DownloadAsset.aspx?id=10720>; accessed: 24 June 2014.

<sup>463</sup> See, e.g., Heismann, G., Collateral Transformation: Neues Risiko im Finanzsystem, Finance, 8 February 2013; Keoun, B., Big Banks Hide Risk Transforming Collateral for Traders, Bloomberg, 11 September 2012; moreover European Commission, Communication, Shadow Banking – Addressing New Sources of Risk in the Financial Sector, COM/2013/0614 final, 4 September 2013, Section 3.3.

several banks offer to take over such clients' lower-quality collateral against a fee and provide them with collateral of a better quality in return, which will be accepted by the clearing house. If the client defaults at a later stage, however, the clearing house will turn to the collateral made available to it whereas the bank will only be able to take recourse to the collateral it has previously accepted. In addition, banks conducting such collateral swaps are frequently invested as shareholders in the clearing houses.<sup>464</sup> The swap thus creates an illusion of systemic stability that does not exist. Transactions of this type can reinforce not only the implicit guarantees for globally systemically relevant banks, but also potential guarantees for the clearing infrastructure.<sup>465</sup> Market surveys by the central banks in the United States and Europe, however, do not indicate a substantial increase of collateral transformation.

– *Proposed solutions* –

**1640.** A claim suggesting itself is to use prohibitions to limit the systemic risk associated with money- and capital-market based leverage finance of all types, the more so if the respective instruments are used speculatively. Indeed, after the eruption of the financial crisis, many and also prominent voices claimed that Europe must put a stop to stock exchange gambling and should “not shy away from simply prohibiting certain types of business, for example, uncovered short-sales or over-the-counter transactions with huge leverage”.<sup>466</sup> Prohibitions of this kind also have many supporters in the public.

**1641.** Prohibitions and constraints can indeed make sense to the extent that leveraged finance is associated with (potentially systemic) risks that are not limited to the distortions of competition following from implicit guarantees. High frequency trading, for instance, was subject to restrictions to prevent sudden drops in market value (“flash crash”) due to excessive trading activity.<sup>467</sup> Similarly, prohibitions were introduced to prevent speculative acceleration of the drop in the market value of securities or sovereign bonds caused by uncovered short sales.<sup>468</sup> In these instances, however, the issue is how to avert systemic risks created intentionally and by means of information advantages through manipulative behaviour, and which can materialise regardless of whether the financial market participant causing them continues to exist or not. In the case of implicit guarantees, in contrast, there is a competition issue because the market participants recognise a bank's systemic importance in respect of its overall business relations and therefore attribute a guarantee of survival to that bank. Legal prohibitions for certain types of trade are not enough to remedy this problem.

**1642.** To counter the increase of implicit guarantees through leveraged finance in the market, a mix of risk-limiting and transparency-increasing laws and regulatory action adapted to the individual case seems to be more promising. This slows down or allows one to recognise any extreme market evolution. Also, the necessary flexibility continues to exist that is necessary to react to new developments and to counter market disruptions caused by a crisis.

**1643.** The expert group under its chairman Liikanen, which was put in place by the European Commission, has worked out an adequate proposal as an alternative to the direct separation of risky trading activities.<sup>469</sup> The proposal provides for general risk limitations for trading assets with non-

<sup>464</sup> Cf. Fitch, Collateral Transformation Drives Central Clearing Risks, press release of 14 June 2012.

<sup>465</sup> Cf. ESRB, Central Counterparties and Systemic Risk, Macro-prudential Commentaries No. 6, November 2013, p. 9.

<sup>466</sup> Federal President Köhler, as quoted from his speech on an Economic Forum in Munich, Reuters, 29 April 2010.

<sup>467</sup> Such a drop in market value occurred, e.g., on 6 October 2010 at the New York Stock Exchange. As to regulatory measures in this area, see, e.g., Schultheiß, [2013] WM 596 (Germany) and Geier/Schmidt, [2013] WM 915 (917-918); Teigelack, [2012] BB 1361 (1364).

<sup>468</sup> Article 12 of Regulation 236/2012 on short selling and certain aspects of credit default swaps, OJ L 86, 24 March 2012, p. 1. In Germany, a similar prohibition existed already from May 2010 to March 2011 (§ 30h WpHG, old version).

<sup>469</sup> Cf. Liikanen, E. et al., High-level Expert Group on reforming the structure of the EU banking sector, supra,

risk-weighted capital requirements (calculated, e.g., in relation to the total amount of trading assets). In addition, the authorities will have the competence to require the separation of risky trading activities after the review of recovery and resolution plans and based on EU-wide consistent criteria. This competence will be subject to accompanying obligations and rules, i.e., the requirement of a clearly structured review process for recovery and resolution plans, the obligation to publish a reasoned decision, and the introduction of sanctions to enforce separation orders.

**1644.** Taking into account that this proposal foresees a step-by-step process, it should be easier and faster to implement than the dual banking solution likewise put forward by the Liikanen Group. Further amendments to the existing provisions do not appear necessary. The non-risk-based capital buffer can be designed in a way that it neutralises the contribution of leveraged finance to the build-up of implicit guarantees even though the calibration of the buffer is complex. The case-specific approach based on the proposal enables the authorities to acquire relatively precise knowledge of the risk situation at institutions with extensive trading activities and to adapt any further required measures to the actual market risks, meaning that a schematic approach can be avoided. In addition, only limited scope should be left to the banks to circumvent the obligations applying to them after the regulators have imposed such obligations. This applies at least if the orders are directly executable.

**1645.** To develop regulation further, the Basel Committee, the FSB and the International Association of Securities Commissions (IOSCO) have recommended other measures that have mostly already been implemented in the EU and Germany or that are to be implemented. These recommendations are framed generally, the systemic risk associated with money- and capital-market based leveraged finance constituting the major focus over individual types of transactions or financial instruments. The organisations recommend, in particular:

- Measures causing the market participants to improve their risk management themselves (e.g., risk retention obligations);
- Measures to increase market transparency (standardisation, reporting obligations, disclosure obligations), and
- the introduction of Central Counter-Parties (CCP) as an essential complement to the market infrastructures (clearing agents).

**1646.** In the EU, large parts of these recommendations have already been implemented through various Regulations and Directives. These provisions, in particular, foresee far-reaching registration, reporting and disclosure requirements for investment firms and banks.<sup>470</sup> Additionally, they impose fundamental rules to be observed for the internal risk management (e.g., governance rules, rules on the avoidance of conflicts of interest).<sup>471</sup> The risk retention rules applying to ABS are highlighted above. These rules supplement the existing EU capital regulation.

**1647.** In addition, several measures were adopted to shift derivatives trade, as far as possible, to regulated trading platforms (including platforms in third countries) and to unbundle the business relations between the financial market participants. A central novelty is the clearing of standardised

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p. 95.

<sup>470</sup> See Article 1 of Directive [...]/2014 on markets in financial instruments repealing Directive 2004/39/EC (MiFID II), preliminary version of the legislative resolution of the European Parliament of 15 April 2014, P7\_TA-PROV(2014)0386, and the legislation quoted there; Articles 7 ff. of Regulation 1287/2006 implementing Directive 2004/39/EC, OJ L 241 of 2 September 2006, p. 1; further Articles 13 ff., 23 ff., 27 ff. of Directive 2006/73/EC implementing Directive 2004/39/EC, OJ L 241 of 2 September 2006, p. 26. As to the increase of transparency, see also Section 3.6.4.2.

<sup>471</sup> Article 11 648/2012 on OTC derivatives, central counterparties and trade repositories (EMIR), OJ L 201, 27 July 2012, p. 1; Articles 23-24 MiFID II; Articles 5 ff. of Directive 2006/73/EC.

OTC derivatives through CCP.<sup>472</sup> The central clearing obligation applies financial counterparties supervised in the EU as well as non-financial counterparties if the latter make use of derivatives on a larger scale. The CCPs themselves have to meet pre-defined admission requirements and continuous capital requirements as they constitute central market infrastructures and may profit from an implicit guarantee of their own.<sup>473</sup> For this reason, they are also subject to stringent organisational requirements, business limitations, and rules on good governance.<sup>474</sup> At the present time, the CCP are being built up. When they are established, they will be expected to actively support the risk control of the authorities and the market participants.<sup>475</sup> Further measures to unbundle business relations add to the establishment of CCP, for example, rules on the provision of services through other investment firms or using contractually bound intermediaries, as well as provisions on the protection of ownership rights in the financial instruments or the money that an investment firm has received from its clients.<sup>476</sup> To increase market confidence and as an element contributing to the neutralisation of implicit guarantees to the benefit of market participants (including CCP), also investor protection systems were established and the obligation was imposed on counterparties in derivative transactions to contribute to so-called default funds, which are administered by the CCP.<sup>477</sup> To the extent that the European rules had to be transposed, they have been implemented in German law in the meantime.<sup>478</sup>

**1648.** The Basel Committee and IOSCO recently published a report on the introduction of margin requirements for non-centrally cleared derivatives as from the end of 2015.<sup>479</sup> The obligation to pay such margin will be imposed on the potentially defaulting party (supplementing the capital requirements applying to the surviving party).

**1649.** To develop the individual competences of regulators further, the recently adopted EU Regulation on markets for financial instruments includes a separate chapter supplementing and significantly broadening the authorities' powers to intervene in the marketing of financial instruments in the individual case (so-called product intervention).<sup>480</sup>

**1650.** An evaluation of the proposed or planned measures to reduce the problem of implicit guarantees with regard to leveraged finance is only possible provisionally. The development of money and capital market regulation is much in flux.

Thus, it must be awaited, in particular, to see to what extent the obligations for the clearing through CCPs will be introduced for relevant transactions and products (particularly, repo transactions, derivatives) specifically. The central clearing and the evening-up ("netting") already done by derivative traders as well as multilateral consolidation ("trade compression") reduce the risk in the markets. In addition, central clearing allows for better risk management and increases market transparency. On the flip side of these advantages, however, also new risks emerge.<sup>481</sup>

<sup>472</sup> Article 4 of Regulation 648/2012.

<sup>473</sup> Articles 14 ff. of Regulation 648/2012.

<sup>474</sup> Articles 26 ff., 36 ff., 47 of Regulation 648/2012.

<sup>475</sup> Articles 40 ff. of Regulation 648/2012.

<sup>476</sup> Articles 26, 29 and Article 16(8), (9) MiFID II; Articles 19-20 of Directive 2006/73/EC.

<sup>477</sup> Article 42 of Regulation 648/2012.

<sup>478</sup> See, particularly, the Finanzmarkttrichtlinie-Umsetzungsgesetz (FRUG), BGBl. I 2007 No. 31, p. 1330.

<sup>479</sup> Cf. BIS and IOSCO, Margin requirements for non-centrally cleared derivatives, September 2013.

<sup>480</sup> Articles 39 ff. of Regulation 600/2014 on markets for financial instruments (MiFIR), OJ L 173, 12 June 2014, p. 84. In existing German law, see also § 4(1) WpHG and special provisions for individual organisms, e.g., §§ 215, 274 KAGB.

<sup>481</sup> Cf. ESRB, Assessing contagion risks from the CDS market, Occasional Paper No. 4, September 2013, p. 39 (also as to problematic asymmetries in contract settlement); ICMA, FAQ on Repo No. 27 (February 2013); <http://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/short-term-markets/Repo-Markets/frequently-asked-questions-on-repo/>; accessed: 24 June 2014; differentiating also: Zimmer/Fuchs, [2010] ZGR 597 (616 ff.) (as to close-out netting).

The banks, but also representatives of the real economy have raised the concern that the new rules could reduce liquidity and constrain the financing options for the real economy. These concerns stand to reason. The Regulators, however, put up with possible constraints on liquidity provision as better control of leveraged finance takes priority and no generally accepted criteria exist so far to discern unwanted speculation from macroeconomically desirable transactions in the individual case. At the same time, it must be assumed that the relevant measures will lead particularly to a reduction in speculative leveraged finance. That said, the regulation must be framed and interpreted restrictively and (i.e., limited to the necessary) in order to avoid unjustified differentiations between different investment segments and strategies and, thus, indirectly unnecessary constraints on the financing of the real economy.

**1651.** The Monopolies Commission shares the FSB's view that regulation is all in all on a good track.<sup>482</sup> It may be assumed that regulation will reduce systemic risk through the divestment of business relationship, the improvement of risk management, and an increase of market transparency. That being said, it must be cautioned against slackening efforts concerning the further evolution of the regulatory framework and the design of the individual competences of supervisors. Concerns arise, in particular, from the central position of banks and non-banks in the derivatives business. Apart from that, the establishment of systemically relevant market infrastructures may give rise to additional new problems (e.g., CCP, transaction registers). However, the money and capital markets are too heterogeneous and develop too quickly for comprehensive regulation to be within the realms of current possibility. Aside from the implementation of the recommendations of the Liikanen Group, the highest priority appears to be that the rules allowing for supervisory product intervention in the individual case can be applied as soon as possible.<sup>483</sup>

**1652.** The Monopolies Commission underlines in this context that the authorities must implement the regulation forcefully and without delay. Indications exist that the rather far-reaching supervisory intervention in the banks' credit business together with persistent regulatory loopholes in the money and capital markets business is a driver for regulatory arbitrage. The volume of the operations not attributed to the regulated business has increased continuously since the financial crisis.<sup>484</sup> Regulatory supervision gains particularly high importance under these circumstances. In consequence, not necessarily more regulation is needed in the years to come, but rather a coherent supervision of the market participants' implementation of the regulation.

### *Limitations of remuneration incentives (bonuses)*

**1653.** In summer 2013, a reform of the European rules on the activities and supervision of banks limited remuneration incentives through variable components of remuneration (bonuses) in a binding fashion, and thereby tightened previous rules.<sup>485</sup> Under the new rules, performance-based remuneration of so-called risk takers (e.g., traders) must meet certain conditions and may not exceed 100% of the fixed remuneration. In so far as Member States allow deviations from these requirements, the variable component of remuneration may generally not exceed 200% of the fixed remuneration. This provision is intended to remove the incentives for risk takers to take on excessive risk with an eye on their bonus. In the meantime, the rules have been implemented in Germany, where

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<sup>482</sup> Cf. FSB, press release of 2 September 2013.

<sup>483</sup> In that regard, it must be regretted that the relevant EU provisions will be applicable only from the beginning of 2017, Article 55 MiFIR.

<sup>484</sup> Cf. FSB, Global Shadow Banking Monitoring Report 2013, 14 November 2013; Global Shadow Banking Monitoring Report 2012, 18 November 2012; Shadow Banking: Strengthening Oversight and Regulation, Recommendations of the Financial Stability Board, 27 October 2011, Annex 1. See moreover Sections 3.7 (shadow banking) and 3.8.1 (increase of capital market financing) below.

<sup>485</sup> Article 94 in conjunction with Article 92(2) of Directive 2013/36/EU (CRD IV). A non-binding provision on remuneration was already included in Directive 2010/76/EU (CRD III).

a general limitation of managerial salaries had been discussed in parallel.<sup>486</sup> In relation to banks, the new rules complement or replace a large number of existing German rules on the remuneration systems in the financial industry.<sup>487</sup>

**1654.** The increasingly stricter remuneration rules seem to already have had an effect in the banking industry, and not only with respect to risk takers.<sup>488</sup> According to initial studies, there is a tendency to award variable remuneration to fewer employees and to reduce its amount. In return, fixed remuneration has been increased in some areas, and offers of other services with money value to employees (trainings, pension contributions, flexible work programmes) have been increased. It is true that BaFin has meanwhile also objected to several circumvention attempts, according to press reports.<sup>489</sup> On the whole, however, many banks take the view that many affected employees will earn less overall than before.

**1655.** The Monopolies Commission takes a cautious position with regard to the new remuneration rules. The rules seem to be difficult to handle. Further, it must be pointed out that risk takers accumulating large systemic risks frequently conduct financial transactions on international markets. Against this backdrop, a provision applying exclusively to European banks creates incentives to move the relevant teams or operations (regulatory arbitrage). Finally, the employees' disposition to incur risks is not neutralised to the extent that they act out of motives that are independent from remuneration incentives (e.g., promotions, appreciation). Apart from the remuneration rules, the enforcement of the rules on the civil liability of risk takers should be tightened further in any case.

#### *Absolute business limitation*

**1656.** Again and again, it is proposed in the discussion to set absolute limits on the volume of banking activities, in order to create an obstacle for the emergence of “too big” banks (“too big to fail”). This means that the business of banks should be limited to a size defined in advance by the balance sheet or in relation to gross domestic product.<sup>490</sup> In Germany, these proposals are unlikely to be received favourably at the present time.<sup>491</sup> That said, they must also be viewed critically. Absolute limitations on independent company growth and divestments in case they are exceeded are not compatible with

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<sup>486</sup> § 25a(5) KWG in the version of the CRD IV-Umsetzungsgesetz. As to manager remuneration, an increase of transparency is planned in addition; see CDU, CSU and SPD, Coalition Agreement, 18th Legislative Period, published on 27 November 2013, p. 17.

<sup>487</sup> See, e.g., §§ 25a(1) No. 4, 45(2)-(5), 53n(3)-(4) KWG, § 64b VAG; Ordinance of 6 October 2010 on the Supervisory Requirements for Institutions' Remuneration Systems (Remuneration Ordinance for Institutions), recast on 16 December 2013, BGBl. I 2013 No. 74, p. 4270; Circular 18/2005 of the Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht – BaFin*) of 20 December 2005 in the version of Circular 10/2012 (BA) of 14 December 2012 on minimum requirements for risk management (MaRisk); SoFFin, *Vergütungsgrundsätze - Neufassung im Hinblick auf das BaFin-Rundschreiben*, February 2010.

<sup>488</sup> The European Banking Authority (EBA) adopted final draft regulatory technical standards on criteria to identify categories of staff whose professional activities have a material impact on an institution's risk profile in December 2013, according to which qualitative and quantitative criteria will apply in that regard (EBA/RTS/2013/11). Thus, for instance, employees belonging to the top 0.3% of all employees in view of their remuneration, or who receive remuneration exceeding EUR 500,000 are considered risk takers. As to the instruments that can be used for variable remuneration, see Regulation 527/2014, OJ L 148, 20 May 2014, p. 21.

<sup>489</sup> This problem is not limited to Germany; see EBA, *Benchmarking of Remuneration Practices at Union Level*, 13. June 2014.

<sup>490</sup> Cf. Haldane, A., *On being the right size*, speech of 25 October 2012, p. 8 with further references.; Johnson, S. in: Dittli, M., *Das Too-big-to-fail-Problem ist größer als vor 2008*, *Finanz und Wirtschaft*, 10 September 2013; www.fuw.ch; accessed: 24 June 2014. An absolute business limit applies to US banks already under Section 622 of the Dodd-Frank Act.

<sup>491</sup> The same should hold for claims to divest banks completely or to socialise them. See, e.g., *Die Linke*, manifesto for the parliamentary election (*Bundestag*) in 2013, pp. 47-48. See also Section 3.6.1.2 above.

the approach of competition policy. Moreover, the forced loss of property in the case of divestiture or expropriation would also raise intricate basic rights questions.<sup>492</sup>

### 3.6.2.3 *Fiscal limitations on trade (financial market tax)*

**1657.** The introduction of a financial market tax is a highly controversial measure to reduce systemic risk, which is particularly difficult to assess regarding its market effects. The European Commission presented a proposal for the introduction of a financial transaction tax (capital transfer tax) within the framework of enhanced cooperation on 14 February 2013.<sup>493</sup> This legislation was addressed to eleven Member States – including Germany – and will consequently affect approximately two thirds of the fiscal and economic capacity of the EU. It pursues several objectives. First, it is aimed at making a new financial crisis less likely by reducing the volatility of the financial markets and curbing transactions that do not enhance public welfare. In addition, it is supposed to make the originators of the financial crisis pay for the cost of the crisis, and thus to remove the “fairness deficit” perceived by the public (“Gains are being privatised – losses socialised”). Finally, it is supposed to generate additional tax revenue without (further) fragmenting the internal market.

**1658.** The plan to introduce a financial transaction tax had first be supported vigorously in the European Parliament and also in Germany. The economy, in contrast, largely opposes the introduction of such a financial transaction tax. The banking associations, but also several industry associations from the real economy, point out that the financial crisis could not have been avoided if such a tax had existed, as the crisis was not caused by traditional financial products. In addition, they claim that the tax also would apply to transactions not associated with any stability risks (e.g., transactions within an associated or corporate group, repo transactions).<sup>494</sup> In order to avoid the charges of the tax, the banks would either pass on the tax to the real economy and small investors, or they would move their business to trading venues where they could circumvent the tax (e.g., London, Luxembourg) and which may not be sufficiently regulated (e.g., some non-European trading venues). In the longer run, the financial industry and the real economy would be weakened. Small investors would be heavily burdened, particularly regarding retirement provisions, because pension funds redeploy their investments up to four times a year. The damage to the economy would not be counterbalanced by an increase in systemic stability since hazardous business activities would be taken over by international investment banks, and since the liquidity exodus could itself decrease the stability of the global financial markets.

**1659.** Originally, a so-called stamp duty was discussed as an alternative, i.e., a tax that had already been introduced by the United Kingdom.<sup>495</sup> Such a duty would be triggered by the acquisition of shares of an undertaking seated in the participating Member State, but it would bring about competitive disadvantages for domestic market participants. Similarly, the idea of a so-called financial activity tax, imposed on earnings, has not met with much success so far.<sup>496</sup> Such a tax would provide fewer opportunities to influence conduct than a financial transaction tax.

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<sup>492</sup> On the issue of compensation in the event of bank divestitures, see Zimmer in: Hellwig/Höfling/Zimmer, Gutachten E/F/G zum 68. Deutschen Juristentag, München 2010, p. G 39.

<sup>493</sup> European Commission, Proposal of 14 February 2013 for a Council Directive implementing enhanced cooperation in the area of financial transaction tax, COM(2013) 71 final.

<sup>494</sup> Regarding repo transactions, however, stability risks cannot be excluded at all; see para. 1630 above.

<sup>495</sup> A stamp duty within the meaning of British law is a tax on the trade with shares of domestic companies at the stock exchange (“stamp duty reserve tax”); see European Commission, Impact Assessment of 28 September 2011 accompanying the document Proposal for a Council Directive on a common system of financial transaction tax (COM[2011] 594), SEC(2011) 1102 final, p. 4.

<sup>496</sup> Cf. IMF, A fair and substantial contribution by the financial sector. Final Report for the G-20, June 2010, p. 66; similarly Schich, S./Kim, B.-H., Systemic Financial Crises: How to Fund Resolution, [2010] OECD Journal: Financial Market Trends No. 2, p. 90 (critically also with regard to the risk-related design of such

**1660.** Due to its character as a regulatory tax, the financial transaction tax necessarily interferes with market development. Nevertheless, the regulatory objectives have been defined only vaguely so far. In that context, a balance must be sought between the constitutional requirements for the design of the tax (Articles 104a ff. of the Basic Law) and the interests of undistorted competition (Protocol No. 27)<sup>497</sup>. From a competition policy perspective, the objective of reducing the systemic risk arising from capital market transaction should be in the foreground.

**1661.** Two starting points exist for the design of the tax: The tax revenue is formed by the product of the tax base and the rate of taxation. To avoid distortions of competition, the tax base should be chosen in a way that the tax covers all capital market transactions of systemically market participants to the utmost extent possible. Admittedly, a counterargument is made that the tax could not have any steering effect if it covered all financial market participants and transactions. Here, however, no attention is paid to the fact that a steering effect can also result from the volume of the eventual tax accrual. It does not seem to be advisable either to differentiate already at the tax base according to the risk structure of the respective transactions. The tax base should be defined in such way that tax liability is triggered with regard to all risky and speculative transactions to the extent possible. Considering the risk structure of the individual transaction would complicate the tax regime without, for example, being able to take adequate account of the re-appraisals of risk in the context of a crisis. In so far as foreign market transactions are intended to be subject to the financial transaction tax based on the issuance principle, this must principally be welcomed as it excludes areas where no tax duty applies. This implies that a truly comprehensive tax base is guaranteed. Nonetheless, it is highly questionable whether tax liability can be enforced in relation to foreign market transactions.

That said, an exception for transactions within a corporate group should be considered because these transactions relate to cases – similar to the restructuring excepted under the proposed Directive – where the relevant securities and derivatives are not traded on the market, meaning that stability risks accruing from such market activity can be ruled out.<sup>498</sup> Apart from that, only narrowly construed exceptions for social reasons are acceptable from a competition policy perspective, for example, to protect the value of consumer investments in products for retirement provisions.

**1662.** The tax rate of the financial transaction tax should be defined in a way that it countervails the market disruptions in a crisis, and thus renders the use of implicit guarantees difficult. At the same time, the incentives to circumvent the tax must be kept to a minimum. In that context, it must be taken into account that a broadly defined tax base makes the repeated taxation of multi-level transactions likely (cascading effect). Moreover, the tariffs discussed so far lead to a considerable tax burden in particular in the case of high trading volumes or frequently repeated transactions. Thus, the tax can have a dampening effect whenever trend-driven and pro-cyclical herding behaviour threatens to develop on the market. Equally, however, the tax can lower the likelihood that particularly short-term oriented market participants anticipate an impending bubble and build up – anti-cyclically – a counterposition.<sup>499</sup> This is because the tax reduces the volume and the number of financial market transactions, but it does so independently from the risk associated with the transactions or existing in the market. To date, it is unclear which of the two effects would prevail in a crisis. That being said, the positive effects of the tax on pro-cyclical market behaviour could be increased by designing the tax itself in an anti-cyclical manner, i.e., by raising the tax rate automatically in case a pre-defined risk measure is exceeded (e.g., in the case of a significantly increased trading volume). The fact that the

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taxes). In this context, the word “earnings” must be understood broadly and can also include, e.g., remuneration and bonuses.

<sup>497</sup> Protocol No. 27 to the Treaties, OJ C 115, 9 May 2008, p. 309.

<sup>498</sup> On the issue of the acquisition of ownership interests by holding entities, see Frey/Bruhn, [2012] BB 1763 (1766).

<sup>499</sup> This is conceivable particularly in high frequency trade. That trade, however, is itself associated with risks; see also para. 1641.

tax is eventually passed on to the customers of the financial market participants can still be best accepted in such a scenario, since the tax would contribute to the short-term stabilisation of the financial system in the case of a crisis. In addition, the regulatory objective of reducing systemic risk militates in favour of raising the tax rate for financial transactions the risk of which is inflated artificially through leverage.

**1663.** On the whole, however, the Monopolies Commission views the financial transaction tax rather critically – despite the steering effects that can generally be expected. On the one hand, it can already be anticipated at this stage that such a tax can and probably will itself distort competition. It must be expected that the affected entities will move their financial transactions into markets where the tax cannot be enforced. The experience with the financial transactions in France and Italy<sup>500</sup> and, earlier on, in Sweden shows that this can lead to a significant exodus or decrease of market liquidity.<sup>501</sup> On the other hand, the expected positive effects of the tax should not be overrated. The dampening effects of the tax would become relevant particularly where the financial market participants exhibit panicking behaviour due to a crisis. However, it is improbable precisely in that specific situation that the relevant effects would be appreciable. It is altogether questionable whether this tax is suited to reduce the accrual of systemic risk – and thereby the amplification of implicit guarantees – significantly. In any case, the financial transaction tax should be embedded in a complete regulatory framework that fundamentally strengthens the confidence of the financial market participants in systemic stability by way of tightened capital requirements and other provisions (e.g., the improvement of the institutional and deposit insurance systems).

**1664.** The International Monetary Fund has recently put forward the proposal of a financial stability tax, which may be an alternative that from a competition policy perspective could be considered under certain circumstances.<sup>502</sup> Such a tax would be triggered by the liabilities and other obligations incurred by a bank, and consequently could absorb the refinancing advantage that ensues for systemically relevant institutions from such interconnections, and that is not already neutralised by the contributions to the resolution and insurance systems as well as increased capital buffers (e.g., the systemic risk buffers). A tax that is, for example, calculated on the basis of the refinancing advantages identified through the analyses of the rating agencies would also absorb the competitive advantage existing in the market participants' view much more directly than the financial market taxes discussed to date. Before such a tax is considered seriously, however, it appears necessary to see the impact of the already introduced bank regulation on the existing implicit guarantees. In addition, similar challenges should come along with the competitively neutral design of such a tax, regarding systemically relevant institutions in other countries or which are active cross-border, as would be the case if a financial transaction tax were introduced.

### 3.6.2.4 *Sanctions*

**1665.** Sanctions can be an effective means to provide incentives hindering the development of implicit guarantees. Public sanctions suggest themselves if banks make their risk takers incur risks (through bonus incentives), but do not make them participate in accruing losses. However, large information asymmetries exist between the parties to a transaction and outside parties in the financial sector, which

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<sup>500</sup> Article 5 of the French Law N° 2012-354 of 14 March 2012; Decree of the Italian Minister for the Economy and Finance of 21 March 2013; further, see Michler/Penatzer, [2012] ORDO 85 (90) with a list of existing financial transaction taxes in large economies worldwide.

<sup>501</sup> Wrobel, M.G., Financial Transactions Taxes: The International Experience and the Lessons for Canada, Background Paper BP-419E (as to Sweden); Coelho, M., Dodging Robin Hood: Responses to France and Italy's Financial Transaction Taxes, 11 March 2014; Colliard, J.-E./Hoffmann, P., Sand in the Chips? Evidence on Taxing Transactions in Modern Markets, 31 July 2013.

<sup>502</sup> IMF, Global Financial Stability Report. Moving from Liquidity- to Growth-Driven Markets, April 2014, pp. 101, 124.

can impede effective supervision significantly if the relevant employees are deterred from cooperating in the detection of risk because of threatening sanctions. Therefore, the Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht* – BaFin) uses primarily its preventive competences to preclude conduct warranting criminal or administrative penalties already in advance.<sup>503</sup> The imposition of repressive sanctions only plays a subordinate or minor role in the context of prudential supervision, according to BaFin.

**1666.** The existing criminal rules are supplemented by a novel provision concerning deficient risk management posing a threat to the system (§ 54a in conjunction with § 25c(4a) and (4b) KWG). Penalties can be imposed under these provisions if the acting individual contravenes an order to remedy an infringement, and if this results in a threat to the survival of the institution.

**1667.** It is doubtful whether this threat of sanction suffices to prevent behaviour that contributes to the development of implicit guarantees, or to punish such behaviour. The relevant provisions include so many imprecise legal terms – despite their level of detail – that they can probably not be made operational.<sup>504</sup> They also do not take account of the various types of implicit guarantee – for example, it is entirely unclear what a “consistent risk strategy” could look like with regard to the issue of “too many to fail”.

**1668.** A threat of sanctions should immediately address the use of implicit guarantees and not only the contravention of administrative orders. Sanctions could be imposed, for example, where risks material for the calculation of the necessary capital are defined in the balance sheet inappropriately low or in a way not comprehensible to BaFin, despite an order to remedy this deficiency, and where the institution later receives State aid without it being excluded that this could have been avoided if the BaFin’s order had been observed. In order to ensure that aid necessary to stabilise the system is still being requested, a higher penalty could be imposed if the institution does not make such request. In any case, no sanction should be imposed with respect to risks that are not related to interactions in which the relevant institution has participated (“too many to fail”).

**1669.** In order to ensure that the provisions on criminal and administrative penalties do not impair the cooperation between the prudential authorities and banks with regard to the risks underlying an implicit guarantee, it could also be considered to supplement the existing sanctions with a whistleblower system.

### ***3.6.3 External growth: introduction of financial merger control?***

**1670.** The introduction of a special merger control regime for banks could be another means to prevent banks from acquiring a systemically relevant position. This proposal has been made repeatedly in the discussion about more stringent banking regulation, but it has not been taken up by the Legislature so far.<sup>505</sup> Indeed, it appears to suggest itself primarily as a secondary step of regulation, after resolution and risk management regulation (particularly, through capital requirements) for systemically relevant institutions are in place and the new regulation can be adapted to these rules.

**1671.** The proposed financial merger control would address a problem of banking supervision that cannot be solved through the existing competition control of mergers. The competition control of

<sup>503</sup> See also Executive Director Röseler in: Rexer, A./Zydra, M., Wir arbeiten eher unter der Oberfläche, *Süddeutsche Zeitung*, 22 April 2013.

<sup>504</sup> The constitutional questions connected to the issue of certainty need not be addressed in this context; see van Kann/Rosak, [2013] BB 1475 (1482) to that end.

<sup>505</sup> Cf. Ratnovski, L., Competition Policy for Modern Banks, IMF Working Paper WP/13/126, May 2013, pp. 11-12.; Rengier, Too Big to Fail als Frage des Kartellrechts, 1st Ed. 2014; differentiating for Germany: Zimmer in: Hellwig/Höfling/Zimmer, Gutachten E/F/G zum 68. Deutschen Juristentag, supra, pp. G 25 ff.; for the US, see Felton, Comment, Too Big to Manage: A Case for Stricter Bank Merger Regulation, 52 Santa Clara Law Review 1081, 1108 (2012).

mergers applies if it can be seen that a concentration would significantly impede effective competition on individual markets. In that context, it is only relevant to what extent the undertaking concerned can expand its market power (scope for conduct) in relation to other market participants by way of the concentration. The absolute size and relevance of its business for systemic stability plays no role in competition law.<sup>506</sup> A financial merger control regime would have a complementing function by taking account of the peculiarities of the financial sector.

**1672.** The financial merger control should be directed at preventing banks from using a takeover (in contrast to internal growth) to acquire a position in the financial system, due to which they can no longer exit the market without threatening or damaging the entire financial system. Therefore, the review of bank concentrations should target the issue whether the concentration creates or strengthens a systemically relevant position (too big or too connected to fail). From a competition policy perspective, it could also be assessed whether the concentration leads to the development of an implicit guarantee in the view of the market. Nonetheless, it appears sensible for the sake of legal uniformity and clarity to select a review criterion that is in line with existing bank regulation (e.g., the capital provisions). With regard to proportionality, such control would be less far-reaching than divestiture rules, as are discussed in the context of dual banking solutions and as have already been introduced in Germany.

**1673.** Apart from that, it is true that German law already includes provisions on the acquisition of significant participations (§ 2c KWG) and on the banks' acquisition of an interest in other undertakings (§ 12a KWG), both provisions allowing to a limited extent for the control of prudentially critical concentrations. The first provision serves to ensure the functioning of banks, the protection of creditor interests, and to facilitate the fight against money laundering, giving BaFin the right to prohibit significant participations running counter to these objectives.<sup>507</sup> The other provision is intended to ensure that superordinate bank entities or financial holding companies receive certain information when they acquire an interest requiring consolidation, and they make it possible to prohibit the continuance of the participation after the acquisition. In both cases, however, the prevention of risks for systemic stability is no express objective of the control.

**1674.** The financial merger control suggested here should fall under the responsibility of the prudential authorities (BaFin), and should in terms of procedure be dovetailed with the competition control of concentrations, closing potential gaps in the competition and the prudential review. Under the existing rules, providing that the prudential and the competition regulators review financial market operations without coordination, such gaps cannot be ruled out.

**1675.** In the longer term, however, financial merger control should not be restricted to banks, but should extend to shadow banks when the regulatory coverage of these is in place, in order to avoid procedural distortions of competition and regulatory arbitrage.

### **3.6.4 Increasing transparency**

**1676.** Transparency is decisive for the prudential authorities and the market participants to identify and appraise the risks associated with the banking business. On the one hand, it is thus a basic condition for supervision which can effectively prevent the development of systemic risk. On the other hand, it enables the market participants themselves to assess existing risk.<sup>508</sup> In that context, also

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<sup>506</sup> Beside that, the systemic relevance of banks is already considered in the competition law context within European State aid control. This control, however, is only relevant where an institution must be supported with State aid; see Section 3.5.3 above.

<sup>507</sup> Cf. resolution proposal of the Finance Committee (7th Committee), BT-Drs. 13/9874, pp. 138-139 (as to § 2c KWG), and Federal Government, Legislative Proposal, Entwurf eines Dritten Gesetzes zur Änderung des Gesetzes über das Kreditwesen, BT-Drs. 10/1441 of 14 May 1984, pp. 36-37 (as to § 12a KWG).

<sup>508</sup> Cf. Basel Committee on Banking Supervision, International Convergence of Capital Measurement and

competition is able to counter the accumulation of systemic risk. The significance of transparency should not be underestimated given the susceptibility of the financial markets to pro-cyclical behaviour, as became apparent in the financial crisis.<sup>509</sup>

**1677.** Regulation presents a mixed picture with regard to the increase of transparency. In many areas, regulation as such goes in the right direction, but its implementation gives rise to novel transparency problems.

### **3.6.4.1** *The level of financial supervision*

**1678.** Increasing the transparency of financial market developments for the prudential and market authorities is a key objective of current banking regulation. This objective is pursued by bolstering, on the one hand, the institutional structures of prudential supervision and by enlarging, on the other hand, the legal competences of the financial authorities.

**1679.** In the context of improving the structure of supervision in the euro area, the current development of a banking union is a central element. The banking union is embedded in a worldwide structure of institutional and systemic supervision (= micro- and macro prudential). The European banking union includes a so-called Single Supervisory Mechanism (SSM), which has a structure with several layers. Therein, the ECB exercised central supervisory functions whereas supervisory questions without cross-border relevance are left to the authorities in Member States, which are more familiar with the issues.<sup>510</sup> The EU competence, however, is not limited to the ECB since other EU institutions can be competent for individual aspects of supervision (e.g., ESRB, EBA).

**1680.** An important measure in the context of preparing for the SSM consists of the implementation of a balance sheet assessment with stress tests for the roughly 130 institutions that will be subject to ECB supervision in the future. Beside that, BaFin reviews the recovery planning of the banks in Germany. The results of the European balance sheet assessment will be available in autumn 2014 at the earliest. Such balance sheet assessments have the objective to review the risk profile and the resilience of large banks with regard to macroeconomic shocks. The currently running exercise is composed of three elements, namely a risk analysis to identify the asset classes entailing most risk (risk assessment), a sample review of asset quality (asset quality review), and the stress test conducted by EBA and simulating a new economic crisis.<sup>511</sup> It is possible that – potentially significant – financial gaps will become apparent on the side of the reviewed banks, which has caused anxiety in Germany in advance and even given rise to demands that the test results and even the test methods must remain confidential.<sup>512</sup> That said, the ECB has announced a tough balance sheet assessment. This should hinder non-identified legacy risks from causing problems after supervision has passed to the ECB and that this compromises the confidence in the ECB.

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Capital Standards: a Revised Framework (Basel II), version of 15 November 2005, 3<sup>rd</sup> pillar.

<sup>509</sup> This applies with certain limitations (regarding dark pools), cf. Articles 7, 11, 20(2) of Regulation No. [...] /2014 on markets for financial instruments (MiFIR), preliminary version of the legislative resolution of the European Parliament of 15 April 2014, P7\_TA-PROV(2014)0385.

<sup>510</sup> Articles 3 ff. of Regulation 1024/2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions (SSM Regulation), OJ 2013 L 287, 29 October 2013, p. 63; and Regulation 468/2014 establishing the framework for cooperation within the Single Supervisory Mechanism between the European Central Bank and national competent authorities and with national designated authorities (SSM Framework Regulation), OJ 2014 L 141, 14 May 2014, p. 1. The ECB can also take on supervisory authority over institutions that are only active in one Member State (e.g., in “too-many-to-fail” cases).

<sup>511</sup> ECB, press release of 23 October 2013.

<sup>512</sup> Schreiber, Banken räumen Bilanzen auf, manager magazin online, 10 October 2013; Schreiber, Deutsche Banken bibbern vor ECB-Stresstest, manager magazin online, 11 October 2013. At that time, the share of loans that are likely to default (nonperforming) was estimated at 7.8% (for 2013) for the five largest Member States of the euro zone.

**1681.** The creation of the SSM must be welcomed as financial market regulation will have an impact beyond individual Member States and because the SSM facilitates the harmonisation of supervisory standards and prevents (further) fragmentation of the internal market. The preparatory balance sheet assessment with stress tests and the concomitant assessment of recovery plans must be welcomed as well. These review measures are appropriate to uncover distortions of competition ensuing from the fact that systemically relevant banks are active on the market without sufficient risk provisions.<sup>513</sup> The banks in the euro area have consequently already increased their risk provisioning for near-to-default credits in advance. It is true that the banking associations have criticised the ECB's use of its own capital definitions and its intention to take higher capital requirements as a basis than what is provided in the law. However, the statutory capital requirements may be too low to provide for sufficient risk buffers.<sup>514</sup> Therefore, the ECB cannot be criticised from a competition policy perspective for going beyond the statutory requirements.

**1682.** The establishment of a preventive regulatory framework for recovery and restructuring planning must be welcomed as well (reorganisation/resolution), which is already in existence in Germany and which will be part of the SRM in the EU in the future (so-called "banking testaments"). This regulatory framework should make it possible that risks potentially threatening the system are revealed and recognised early on, putting prudential supervision in a position to impose the necessary counter-measures.

**1683.** The banking union, as a consistent regulatory framework for the supervision, resolution, and financing, must in principle be viewed positively.<sup>515</sup> The banking union not only established a framework for homogeneous prudential standards, but it also allows for the stronger integration or a farther-reaching information exchange between supervisory authorities. That said, it is problematic that no tightly organised supervisory structure has been implemented so far, but that the components of the organisation of supervision have been implanted into a barely permeable bureaucratic network. Already now, the market participants are exposed to requirements or statements by a multitude of institutions and bodies in relation to themselves or their respective business partners. This situation will still worsen. The following table attempts – without any claim to completeness – to provide an overview of the relevant institutions:

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<sup>513</sup> This is true although, in advance, the assessment requirements have been criticised as not practical and the assumptions of the stress test as not always realistic; see Neubacher, ECB-Bilanztest wird zur Stressroute, *Börsen-Zeitung*, 25 March 2014; ECB setzt Banken Sechsmonatsfrist, *Börsen-Zeitung*, 29 April 2014; as to the criteria of the stress test, see Neubacher, Aufseher simulieren Konjunkturreinbruch, *Börsen-Zeitung*, 30 April 2014.

<sup>514</sup> See Section 3.6.1.1 above, particularly paras. 1560 ff., 1584 f., 1591.

<sup>515</sup> This applies with the limitations set out in Sections 3.6.1.1 and 3.6.1.3.

Table VI.6: Relevant supervisory institutions

	Micro-prudential	Macro-prudential	Financial market stability	Others
<b>International</b>	Basel Committee (BIS)	FSB	IMF	---
<b>Supranational (EU)</b>	ECB, EBA/ESMA, European Commission (DG MARKT)	ESRB	ESM	Special supervisory authorities (e.g., European Commission: DG COMP)
<b>National</b>	BaFin, Bundesbank, Federal Ministry of Finance	Financial Stability Committee	FMSA	Special supervisory authorities (e.g., FCO)
<b>Regional</b>	Ministries of Finance in the <i>Länder</i> , savings bank regulators	---	---	Special supervisory authorities (e.g., LKartB, trade supervisors)

Source: own illustration.

Aside from that, the banks must also take into account the recommendations and statements of special committees established for general or special issues (G 20, Liikanen Group, etc.), which may act as an impulse for further regulation.

**1684.** The Monopolies Commission considers this network of institutions and other bodies to be problematic for reasons of regulatory transparency. Also in the present context, it does not comment on questions of competence, but it warns nevertheless that problems of conflicting competences may arise in case the existing or planned supervisory rules provide for double competences, require interpretation, or contain gaps.<sup>516</sup> Competence conflicts can also follow from the need to interpret rules that principally are relevant for determining the competent authority only in an indirect way (e.g., the capital rules and the provisions on risk determination).

**1685.** The allocation of competences between the field of macro-prudential supervision, which is relevant in the present context, and the field of micro-prudential supervision is not entirely convincing. In order to exclude contradicting approaches, it is sensible to have divisions of the same authorities exercise the powers of macro- and micro-prudential supervision. The outsourcing of special bodies and committees for macro-prudential supervision appears unnecessary, the more so as these bodies have barely any decision-making powers. With regard to micro-prudential supervision, the allocation of competences to several institutions in Germany is unnecessarily complex (see §§ 6 ff. KWG). In that context, complexity is ever more increased by the Bundesbank's additional competences in the area of monetary policy.

**1686.** The bodies and committees responsible for macro-prudential supervision detect or monitor systemic risk to trigger legislative action or regulatory proceedings. At least at the levels above the national level, competition expertise is also represented in these bodies.<sup>517</sup> In the German Financial Stability Committee, no provision is made at the present time for the integration of competition

<sup>516</sup> See, e.g., Article 14 (authorisation/closure of banks) and Article 5(1) and (2) (measures of macro-prudential supervision) SSM Regulation on overlapping competences; and Speyer, EU-Bankenunion: Richtige Idee, schlechte Durchführung, EU Monitor (DB Research), 20 September 2013, p. 10. The SSM Framework Regulation, however, now includes general principles on cooperation and the allocation of competences (see Articles 3 ff.).

<sup>517</sup> For instance, the OECD and the European Commission are represented on the Financial Stability Board. In the Advisory Scientific Committee of the ESRB, one member is a competition economist.

expertise even though questions of systemic relevance are at the interface of prudential and competition regulation. That said, the Monopolies Commission is prepared to contribute to the work of the Committee by way of exchange on the issue of implicit guarantees.

**1687.** The institutions responsible for micro-prudential supervision have received a vast amount of additional competences in the context of the reform of financial market regulation. To increase market transparency for the competent authorities, moreover, the banks' existing reporting obligations were increased significantly. The individual provisions frequently appear to be sensible and can be the basis on some markets in the first place to establish financial supervision that can effectively counter potential systemic threats. In that context, it must be taken into account that even very broad powers may be necessary in some areas of regulation if regulatory gaps might otherwise arise (e.g., in the areas of monetary and capital markets).<sup>518</sup> That being said, it is no longer possible simply to discern a coherent overall concept, in the sense that the relevant regulatory requirements and competences are limited to the necessary minimum and that the competences of different supervisors are aligned with each other.

**1688.** In the Monopolies Commission's view, it appears necessary to further develop the existing regulation that often had to be worked out under much time pressure. This should be done in accordance with competition principles and should increase the coherence of regulation. The Monopolies Commission welcomes the Government's intention, as formulated in the coalition agreement, to review the co-operation of the regulatory measures adopted so far together with BaFin with respect to their practicability and targeted precision.<sup>519</sup>

### **3.6.4.2 The level of professional market participants**

**1689.** To date, financial market regulation is expected to increase market transparency in the first place for the supervisors, and only in second between the financial market participants. On the level of the financial market participants, however, increasing market transparency can likewise improve the possibilities to neutralise risk at an early stage, namely when information asymmetries are reduced and the market actors are put on a position to identify risk in the markets themselves and to ask for market-adequate remuneration for the assumption of such risk.

**1690.** That being said, the professional market participants (banks, other financial market intermediaries) complain that the many regulatory initiatives following the financial crisis have resulted in opaque and contradictory rules, and altogether to over-regulation.

**1691.** This criticism is understandable given the sheer volume of regulation since the financial crisis. However, regulation must take account of the complexity of the financial business. The Monopolies Commission thus, adopts a differentiating position.

**1692.** Financial market regulation contains important elements to increase market transparency. In that respect, in particular the increasing harmonisation and standardisation at EU level must be highlighted (*Single Rulebook*). In many areas, financial market reform has created comparable competitive conditions for the first time. This comparability is key to allow market participants to recognise risk on cross-border markets and, thus, in particular on the money and capital markets that are particularly susceptible to the development and the spread of systemic risks. Aside from that, the market participants will benefit from the publications about the conducted stress tests and from the existing or envisioned obligations to make business figures and other information transparent.<sup>520</sup>

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<sup>518</sup> See Section 3.6.2.2 above, particularly paras. 1642 ff.

<sup>519</sup> CDU, CSU and SPD, Coalition Agreement, 18<sup>th</sup> Legislative Period, published on 27 November 2013, p. 46.

<sup>520</sup> See, e.g., Article 429 of Regulation 575/2013 on the potential introduction of a leverage ratio (as an indicator for bank capitalisation that is also accepted on the market); Articles 431 ff. of Regulation 575/2013, § 26a

**1693.** The European legislature has harmonised in particular the capital and liquidity requirements for banks to a large degree. In addition, the reporting transparency has been improved, most recently through the reform of the auditing rules.<sup>521</sup> Moreover, the regulatory standards for publication systems and the provision of trading data has been improved.<sup>522</sup>

**1694.** A particular problem consists in information asymmetries especially with regard to complex securities and derivatives that are traded over the counter (OTC). Such information asymmetries can significantly impede the risk assessment for such financial instruments. Hence, new rules to transfer the OTC trade to central infrastructures have been worked out at EU level. To the extent possible, these rules allocate the business with financial instruments to exchanges, exchange-like and other organised trading platforms.<sup>523</sup> Additionally, the rules on central repositories for exchange-traded securities have been reformed.<sup>524</sup> Further, the rules on investor information have been fundamentally revised.<sup>525</sup> As is mentioned above, an obligation of CCP clearing has been introduced with regard to standardised OTC derivatives; moreover the conclusion of derivative transactions must be notified to transaction repositories since February 2014.<sup>526</sup>

**1695.** The establishment of central financial infrastructures creates the risk that such infrastructures as well can benefit from implicit guarantees. It means, however, that this risk is concentrated in undertakings that are subject to special supervision, and that the systemic risk at other market participants will consequently be lowered.

**1696.** Apart from that, the European Commission recently published a proposal for a Regulation to increase the transparency of securities financing transactions, i.e., of transactions where the assets belonging to a counterparty are used to generate financing means (e.g., securities lending, repo transactions).<sup>527</sup> Such transactions are principally desirable because they increase the liquidity of the markets, facilitate financing, and support price determination. However, they can be used for maturity and risk transformation, and thus to create credit, and provide possibilities to build up high reciprocal risk positions. Securities lending transactions moreover contribute to interconnectedness. For these reasons, securities financing transactions can also increase the risk of crisis-related runs. The Commission proposal is targeted at increasing market transparency with regard to securities financing transactions, namely in three respects: (i) to identify systemic risk, (ii) to inform the investors whose assets are being used for securities financing transactions, and (iii) to improve the transparency of securities lending.

**1697.** The described rules are being complemented through technical standards intended to standardise more products and transactions. The ECB has moreover started an ABS loan level initiative that imposes *loan-by-loan* information requirements for ABS accepted as collateral. The initiative is meant

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KWG (disclosure), § 29(2) KWG.

<sup>521</sup> See Regulation 537/2014 on specific requirements regarding statutory audit of public-interest entities, preliminary document PE-CONS 5/14 [final version: OJ L 158, 27 May 2014, p. 77]; Directive 2014/56/EU amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts, OJ L 158, 27 May 2014, p. 196. Concerning many issues, the reform is oriented at principles laid down in the new regulation of the rating industry; see Section 3.6.4.4 below in that context.

<sup>522</sup> See, e.g., Articles 64(2), 65(1), (2) of Directive [...] /2014 on markets in financial instruments repealing Directive 2004/39/EC (MiFID II), preliminary version of the legislative resolution of the European Parliament of 15 April 2014, P7\_TA-PROV(2014)0386.

<sup>523</sup> So-called Multilateral Trading Facilities (MTF) and Organised Trading Facilities (OTF); see Articles 18 ff., 31 ff. MiFID II and Recital 164.

<sup>524</sup> See, particularly, Articles 1(1), 30-31 of Regulation [...] /2014 on improving securities settlement in the European Union and on central securities depositories (CSDs), preliminary version of the legislative resolution of the European Parliament of 15 April 2014, P7\_TA-PROV(2014)0388.

<sup>525</sup> Articles 24 ff. MiFID II.

<sup>526</sup> Articles 14 ff. and Article 9 of Regulation 648/2012 (EMIR); see also paras. 1645 ff. above.

<sup>527</sup> European Commission, Proposal of 29 January 2014 for a Regulation on reporting and transparency of securities financing transactions, COM(2014) 40 final.

to increase the transparency of the ABS markets, and thereby to allow for better risk assessments regarding ABS.<sup>528</sup>

**1698.** Despite these positive individual elements, however, the challenge persists that the market participants must indeed be able as far as possible to become aware themselves of developing systemic risk, and to do so at an early stage, in order to be able to counteract future crises independently. That said, concern is warranted that the required market transparency is sometimes unnecessarily impaired through the regulation, which is altogether extremely complex. For example, the capital and liquidity rules are exclusively oriented at the model of large universal banks. As highlighted above, provisions in existence for a longer time are sometimes barely comprehensible nowadays – not least due to the many amendments and modifications in recent years. In that respect, national regulation is still much more difficult to comprehend than the European rules. The amount and the level of detail of the rules to be observed appear to be excessive in some cases.<sup>529</sup>

**1699.** This density of regulation can itself increase risk. The financial market participants should still be able to understand the rules applying to themselves and to the operations in the relevant market, but they may not be able without further ado to understand which additional rules apply to their business partners and the latter's business on upstream or downstream or neighbouring markets.<sup>530</sup> This means that it becomes increasingly complicated for the market participants to become aware of and correctly assess any risks going beyond the individual transaction and having a systemic character.

**1700.** In the Monopolies Commission's view, it therefore appears unavoidable to constantly work on the simplification and improvement of the regulation in order to adapt it ever more closely to the market conditions and the actual risk on the market. It therefore welcomes unconditionally the regular review obligations that have become more and more important in recent international financial regulation.

**1701.** In addition, the Monopolies Commission recommends increasing the incentives for the use of simple financial instruments and easy transactions. As far as can be seen, few incentives exist so far to make the market participants prefer simpler transactions to those that are structured in a more complex way, apart from increasing standardisation.<sup>531</sup> As a market-adequate tool, it could be recommended to empower the supervisory authorities to subject individual types of business transaction to increased capital requirements or margin requirements (derivatives), subject to the given market situation.<sup>532</sup>

**1702.** However, professional market participants can also deliberately exploit the opacity resulting from unclear or incomplete regulation, and may consequently occasionally even have an interest in such opacity. In the traditional deposits and loan business, this should be the case only to a limited degree. It could be the case, though, in some business areas where particularly larger and special institutions are active and where complex products are being traded (e.g., multiple securitisations, certain fund products), where the business is international (e.g., with regard to securities and

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<sup>528</sup> See ECB website: <http://www.ecb.europa.eu/mopo/assets/loanlevel/html/index.en.html> .

<sup>529</sup> For instance, the uninitiated reader in German law already fails at § 1 KWG, i.e., to grasp the differentiation between credit institutions (*Kreditinstitute*) or CRR credit institutions (*CRR-Kreditinstitute*), financial service institutions (*Finanzdienstleistungsinstitute*), financial undertakings (*Finanzunternehmen*), investment firms (*Wertpapierfirmen*) or CRR investment firms (*CRR-Wertpapierfirmen*), securities trading companies (*Wertpapierhandelsunternehmen*) and securities trading banks (*Wertpapierhandelsbanken*). In addition, there are investment services companies (*Wertpapierdienstleistungsunternehmen*) within the meaning of the WpHG. The divergent legal terms of EU law seem to be sufficient.

<sup>530</sup> According to a study, however, 40% of the banks in Germany had no overview of current regulatory obligations at the end of 2013; see PPI AG, press information note of 27 November 2013.

<sup>531</sup> It remains to be seen, however, what the effects will be of the Regulation on key information documents for investment products, preliminary version of the legislative resolution of the European Parliament of 15 April 2014, P7\_TA-PROV(2014)0357.

<sup>532</sup> See also already Sections 3.6.2.1 and 3.6.2.2 above, particularly paras. 1646, 1648 (*as to leveraged finance*).

derivatives), or where transactions take place particularly rapidly and/or within structures that are interconnected in a complex manner (e.g. in interbank operations).<sup>533</sup> Market transparency is reduced further by the fact that derivatives and short selling distribute risks independently from the underlying or base transaction across markets and to potentially any market participants.<sup>534</sup> There is still no comprehensive regulatory answer to the exploitation of opaque or incomplete regulation.

**1703.** The Monopolies Commission is aware of the fact that the high complexity of the financial markets makes the improvement of market transparency extremely difficult, especially if the market participants show only limited initiative in that respect. Nevertheless, it considers it to be necessary that the complexity of regulation be reduced particularly with regard to the financial market participants' interaction with each other. In that context, it is very sceptical as to the proposals forwarded occasionally that the financial markets should be simplified through the prohibition of complex products. Such prohibitions provide incentives for regulatory arbitrage and are consequently hardly enforceable. Thus, they lead only to an illusion of security for investors.

### **3.6.4.3** *The level of consumers*

**1704.** Taken together, consumers form an important group of market participants in the retail deposits business and also share the liability for the failure of banks where the bail-in tool applies. In addition, consumers are liable in the case of a bail-out if the charges of a bank failure are not assumed by the equity and outside investors. For these reasons, consumers have a legitimate interest to be able to realise the risk of a bank failure.

**1705.** That said, banking regulation is designed in a way that non-professional market participants are generally not able to discern the risks imposed on them in the financial markets. They are not able to discern either whether their respective bank is systemically relevant, and to what extent they would be liable as bank customers or taxpayers if an implicit guarantee is called upon.

**1706.** In the context of consumer protection rules, the Legislature has primarily increased the advisory obligations towards consumers so far.<sup>535</sup> No specific obligation exists to inform consumers of their liability for systemic risks. This is admittedly not surprising given the generally low likelihood of consumers having to step in for such risks. Nevertheless, consumers' present awareness of the risks they assume with their financial investments should be heightened, and the independent reflection on the risks which consumers agree to when making deposits or investments at systemically relevant institutions. To develop appropriate measures, it stands to reason to involve BaFin's advisory council on consumer matters, which advises the institution from a consumer perspective in the fulfilment of its respective prudential tasks.<sup>536</sup>

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<sup>533</sup> See, e.g., ESRB, *The Structure and Resilience of the European Interbank Market*, [2013] Occasional Paper No. 3; ESRB, *Assessing contagion risks from the CDS market*, [2013] Occasional Paper No. 4. Especially regarding proprietary trade, it is unclear to what extent that trade has been reduced (as is claimed by the banks) or actually still exists; see: Beecken, *Und sie zocken doch*, FR, 14 January 2013 (as to the situation in the US).

<sup>534</sup> When assessing the associated risk, it must however be taken into account that short selling also can reduce risks, e.g., when buyers purchase contrary to the market development and thereby counteract a decline in market prices.

<sup>535</sup> § 34 (2a)(1) WpHG in conjunction with § 14 WpDVerOV.

<sup>536</sup> See BaFin, web publication of 20 June 2013; accessible: [http://www.bafin.de/SharedDocs/Veroeffentlichung/en/DE/Meldung/2013/meldung\\_130620\\_verbraucherbeirat\\_sitzung.html](http://www.bafin.de/SharedDocs/Veroeffentlichung/en/DE/Meldung/2013/meldung_130620_verbraucherbeirat_sitzung.html). A possible measure would consist in mandatory information on the amount of deposit insurance in the actual case and the associated risk of loss.

### 3.6.4.4 Ratings

**1707.** The rating agencies' assessments make it easier for supervisors as well as professional and non-professional market participants to correctly appraise the risks flowing from a business relationship with a financial market participants and associated with the financial products markets. This is at least the case if the ratings are provided free of self-interest, if they are meaningful and comprehensible. To remedy the deficiencies emerging during the financial crisis, the European legislature has passed a number of rules in recent years.<sup>537</sup> These rules are meant to prevent conflicts of interest in the rating process or at least to regulate how they are handled, to improve the quality of the methods and the rating results, and to ensure efficient supervision of the rating agencies.

**1708.** The risk of a conflict of interest is particularly apparent in the case of the common issuer-paid ratings.<sup>538</sup> To allow for effective supervision and to avoid conflicts of interests, various organisational obligations were introduced, for example, the duty for rating agencies to have their seat and be registered in the EU if they are active there, and rules on the organisation of their supervisory or management board. Other changes worth highlighting include the express prohibition to provide advisory services to rated undertakings and to make formal or informal recommendations with respect to the design of financial instruments, the introduction of a rotation system for the rating of re-securitisations of the same originator and for the employees participating in a rating. The employees must have sufficient knowledge and experience for the provision of ratings, without however precise conditions being made in that respect. In addition, the rating agencies have to fulfil farther-reaching information and transparency obligations the core of which consists in the duty to send the issuer-paid ratings to a central European rating platform of ESMA (EURIX) for publication. Investor-paid ratings are exempted from this obligation. Finally, the rating agencies' civil liability was put on new legal basis in EU law in order to provide more effective compliance incentives by using the threat of sanctions.<sup>539</sup>

**1709.** The fact that issuer-paid ratings were maintained has repeatedly been criticised since the financial crisis because conflicts of interest are more likely if the relevant rating agency provides other services to the issuer (risk of rating bias). These conflicts of interest are not completely abolished through the present prohibition of advisory services as the agencies can still render so-called ancillary services, and it remains unclear how the limit is to be drawn. In addition, the practice has developed, according to expert publications, that the issuer structures several financial products independently and only issues the product that is best rated by a rating agency.<sup>540</sup> That said, issuer-paid ratings can be reconciled with transparency obligations much more easily than investor-paid ratings. Moreover, the current rotation system may be enlarged beyond re-securitisations under the circumstances, in order to limit the risk of conflicts of interest further.<sup>541</sup>

**1710.** For now, the project of a European rating agency to limit the dominance of the three American agencies Fitch, Moody's, and Standard & Poor's has not been pursued much further. Instead, smaller rating agencies profit from exceptions from the statutory provisions on stakeholdings in the agency and rotation. In addition, some rules introduced in 2013 contain measures to reduce legislative references to ratings. Similarly, the financial market participants have to observe obligations to

<sup>537</sup> See Regulation 1060/2009 in the version of Regulation 462/2013, OJ L 146, 31 May 2013, p. 1; further, see Regulation 946/2012 on rules of procedure as to fines imposed by the rating supervisory authority ESMA, and Regulation 447/2012 on technical regulatory standards.

<sup>538</sup> So-called rating outlooks are here treated like ratings; cf. Article 3 lit. w of Regulation 1060/2009 in the version of Regulation 462/2013.

<sup>539</sup> See, however critically due to the still high conditions for liability, e.g., Blaurock, [2013] EuZW 608 (611); in detail also Wojcik, [2013] NJW 2385.

<sup>540</sup> Bauer, [2013] BB 363 (364).

<sup>541</sup> Recital 13 of Regulation 462/2013. However, it cannot be ruled out based on the existing provisions that the same employees issue ratings despite the rotation; cf. Articles 6b, 7 of Regulation 462/2013.

conduct their own credit assessments in contrast to an excessive use of ratings. These provisions must partly be transposed into national law and can also trigger changes in the jurisprudence, which are still not foreseeable (e.g., regarding the liability of investment advisers).<sup>542</sup> In that regard, it is necessary to wait and see how things develop further.

**1711.** On the whole, however, it must be assumed that the measures adopted with regard to ratings may contribute to more risk-adequate supervision and to more informed decisions by the financial market participants. In particular, they will operate against the questionable delegation of responsibility associated with the practice to use the agencies' ratings even where this is not necessary in substance. The regulatory approach to enhance quality competition in relation to ratings by dint of rotation and the strengthening of small agencies must equally be welcomed.<sup>543</sup> The originally discussed establishment of a European rating agency would not necessarily have better results in that context, but it would increase the risk of politically influenced ratings.

### ***3.7 Necessary expansion of the regulation (shadow banks)***

**1712.** Besides banks, non-banks exist that conduct forms of credit intermediation and can accumulate systemic risk thereby (so-called shadow banks).<sup>544</sup> In the public debate on shadow banks, a mixture of ignorance and moral prejudgement are still predominant. To a certain extent, this is understandable as shadow banks can be the cause of substantial macroeconomic risk. Nevertheless, it is disturbing that financial market participants in this business are sweepingly equated with economic vermin (locusts) in Germany.<sup>545</sup>

**1713.** From a competition policy perspective, the shadow banking industry shows a differentiated picture. On the one hand, the problem of implicit guarantees is also present in this context and moreover the problem of competition distortions due to the regulatory arbitrage of investors shifting risks from the regulated areas into the non-regulated areas of shadow banking (thereby withdrawing them from the reach of regulation). On the other hand, shadow banking can be a good addition to regulated banking to the extent that banking cannot fully satisfy the demand for financial services of the real economy.<sup>546</sup> In that respect, the existence of shadow banks would be evidence of the fact that financial innovations asked for by the market principally cannot be prevented by means of restrictive banking regulation.<sup>547</sup>

**1714.** Finally, it must be taken into consideration that many shadow banks are by no means non-regulated, but are mostly subject to special rules. Thus, regulation is only wanting to the extent that these financial market participants are not subject to regulation that is typical for banks.

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<sup>542</sup> As to the transposition, see: Federal Government, Entwurf eines Gesetz zur Verminderung der Abhängigkeit von Ratings, BR-Ds. 185/14.

<sup>543</sup> That sort of forced rotation should also have to be considered for auditors; cf. European Parliament, Committee on Legal Affairs, press release of 25 April 2013, Ref. 20130422IPR07532; Competition Commission, Statutory audit services for large companies market investigation, Report of 15 October 2013, accessible: <http://www.competition-commission.org.uk/our-work/directory-of-all-inquiries/statutory-audit-services>; Maisch, Investoren attackieren Wirtschaftsprüfer, Handelsblatt, 16 January 2013, about the different positions.

<sup>544</sup> Cf. FSB, Strengthening Oversight and Regulation of Shadow Banking. An Overview of Policy Recommendations, 29 August 2013, p. IV.

<sup>545</sup> Critically also: Council of Economic Experts, Annual Economic Report 2005/2006, Die Chance nutzen - Reformen mutig voranbringen, Wiesbaden 2005, paras. 694 ff.; Marin, B., Der "Parasiten"-Komplex, Der Standard, 12 October 2012 (from the Austrian perspective).

<sup>546</sup> In this sense, see European Commission, Green Paper on shadow banking, COM(2012) 102 final of 19 March 2012, p. 2.

<sup>547</sup> In contrast, innovations limited to the financial sector and without use for the real economy may have to be questioned; cf., provocative, Volcker, chairman of the US Economic Recovery Advisory Board: "The only thing useful banks have invented in 20 years is the ATM", NY Post, 13 December 2009.

### 3.7.1 *Problems of regulatory grasp*

**1715.** Isolating the market participants allocated to the shadow banking industry is difficult. The regulators include in the shadow banking economy such undertakings that

- raise funding with deposit-like characteristics;
- perform maturity and/or liquidity transformation;
- allow credit risk transfer;
- use direct or indirect leverage.<sup>548</sup>

It is, however, controversial – not least in view of the term “shadow banks” that is frequently interpreted as pejorative – which undertakings meet these conditions and to what extent they do it. Based on a broad understanding, shadow banks include the SIV of banks as well as private equity firms, hedge funds, most investment funds (particularly, money market funds, pension funds), sovereign wealth funds, foundations, and insurance companies. The listing above, however, is subject to an important condition, and it is not exclusive. What is decisive is the economic function that the market participants exercise in the individual case. Thus, to identify the relevant economic functions, the FSB looks at the individual activity of the market participants, i.e., the kind of use that is made of financial instruments (shares, bonds, derivatives, etc.) and the pursued objectives (e.g., credit supply/insurance, funding).<sup>549</sup>

**1716.** Regarding potential inroads for regulation, it is necessary to clearly allocate regulatory responsibility for the relevant activity to the market participants. It therefore also makes sense to take into account whether and to what extent the relevant market participants pursue their own business strategy or objectives. In this context, two groups can be distinguished:

- On the one side, there are the organisms that have their own management and themselves invest strategically in financial instruments (e.g., hedge funds, private equity firms). Investors standing behind these firms generally occupy only the role of financial investor. That is, they decide whether they invest or continue their investment, but they do not meddle in operational management.
- On the other side, there are the organisms that stand under the decisive influence of other financial market participants (funds, SIV). These organisms are “captive”, i.e., they do not have their own management. The investors standing behind (e.g., banks, pension or sovereign wealth funds, insurance companies) frame the operational management actively as strategic investors.<sup>550</sup>

In that context, the methods of influence are interrelated and reflective. That is, organisms also invest in the financial instruments of other organisms (e.g., funds of funds) or in the financial instruments issued by the investors standing behind (e.g., insurance shares).

**1717.** For organisms with their own management, it is possible that the management manages the investment assets directly. For organisms with restricted holding periods (closed funds), however,

<sup>548</sup> Cf. FSB, *Shadow Banking: Scoping the Issues*. A Background Note of the Financial Stability Board, 12 April 2011; and following it: European Commission, *Communication from the Commission to the Council and the European Parliament, Shadow Banking – Addressing new sources of risk in the financial sector*, COM(2013) 614 final, 4 September 2013, p. 3.

<sup>549</sup> Cf. FSB, *Strengthening Oversight and Regulation of Shadow Banking. An Overview of Policy Recommendations*, 29 August 2013, p. 6; *Strengthening Oversight and Regulation of Shadow Banking. An Integrated Overview of Policy Recommendations*, Consultative Document, 18 November 2012, pp. 3-4.

<sup>550</sup> Wealthy private investors can count to these “strategic investors” as well (so-called family offices).

types of limited companies are more common where the general partner is a limited liability management company that manages the undertaking, and the limited partners are the investors that provide their money to one or several funds.<sup>551</sup> The management administers the funds through the management company and attracts new investors. Required additional expertise is secured from the outside (from lawyers, accountants) on a project basis, the same holds for necessary outside capital (through bank loans). Accordingly, listed organisms with their own management consist of partnerships limited by shares.

**1718.** Therefore, a regulatory approach tied to the management suggests itself at least for organisms with their own management to monitor the risks of the relevant business. This approach was chosen in the European AIFMD.<sup>552</sup> However, this regulatory approach does not address the relationship to the investors standing behind the organism. Consequently, it does not take into account that these investors are likewise active on the market indirectly through the organisms with their own management and directly through organisms without a management, and that they accordingly take themselves risk-relevant decisions. In that regard, it is advisable to adopt measures targeting the relevant transactions or the consolidated accounting of these transactions.<sup>553</sup> This is also important for the regulation of shadow banking in relation to implicit guarantees.

### ***3.7.2 Implicit guarantees in the shadow banking industry***

**1719.** It must be assumed that also shadow banking operations can bring about implicit guarantees. On the one hand, implicit guarantees can arise for the organisms active as shadow banks if they are viewed as independent market participants on the market given their own management. On the other hand, however, implicit guarantees can also arise or be strengthened for the investors in these organisms.

**1720.** In the view of the relevant regulators, this problem of implicit guarantees has increased in recent years. According to FSB findings, the shadow banking sector has expanded considerably since the financial crisis. In 2012, shadow banks managed approximately USD 71 trillion, that is roughly EUR 55 trillion (EUR 55,400,000,000,000). That is 117% of worldwide GDP.<sup>554</sup> The business of the used organisms and/or the investors standing behind exhibits one or more of the following traits:

- the use of high leverage;
- unregulated (use of regulatory havens) and opaque business (reporting);
- susceptibility to massive withdrawals of funds (run);
- connectedness and, in the case of default, contagion effects (spill over).

The systemic risk potentially leading to implicit guarantees in the individual case, however, can hardly be outlined in the abstract.

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<sup>551</sup> In German law, closed domestic investment organisms may only be organised in the form of investment corporations with fixed capital (*Investmentaktiengesellschaft mit fixem Kapital*) or closed limited investment partnerships (*geschlossene Investmentkommanditgesellschaften*), § 139 KAGB.

<sup>552</sup> Directive 2011/61/EU on Alternative Investment Fund Managers, OJ L 174, 1 July 2011, p. 1. The term “management” must be understood broadly in the current context and, in addition to the acting individuals, also includes the management company (see Article 4(1) lit. b of Directive 2011/61/EU).

<sup>553</sup> This is also the position of the European Commission, European Commission, Communication from the Commission to the Council and the European Parliament, Shadow Banking – Addressing new sources of risk in the financial sector, COM(2013) 614 final, 4 September 2013, p. 5.

<sup>554</sup> Cf. FSB, Global Shadow Banking Monitoring Report 2013, 14 November 2013, pp. 2, 8-9.

### 3.7.2.1 Private equity

**1721.** Private equity financing is a form of asset management traditionally seen as Anglo-Saxon in character. In fact, however, it is a business mainly driven by the situation on the spot, in which European firms (e.g., Apax, BC Partners, CVC, Candover, Cinven, Permira) or the subsidiaries of non-European firms (e.g., Blackstone, Carlyle, KKR, TPG, Warburg Pincus) invest with their local management in Europe. Private equity firms invest in non-listed companies or in still listed companies that are delisted after the transaction. Thus, it is a financing model chiefly targeting the small and medium-sized business (*Mittelstand*) in Germany. The common characteristic of private equity transactions is the investment by means of a fund with the objective to increase the value of the investment within a medium-term planning horizon (2 to 8 years). The financing volume (disregarding seed and start-up financings) is often in the area of EUR 10 million to EUR 100 million. Unlike in traditional investments in listed companies, dividends are not a primary goal of the investments.

**1722.** Two types of business operation can be counted to private equity investments in the traditional sense:

- Growth financing (venture capital in a broader sense), i.e., types of risk capital provision for newly created enterprises (seed or start-up financing), for expansion purposes, as bridge financing, or turning around companies in difficulty. In Germany, also public banks engage in this business to a large extent (e.g., KfW, Landesbanken).
- Take-over investments (buy-out) where the money of the private equity firm does not flow into the target undertaking, but to its shareholders. In these cases, often undertakings or parts of undertakings are involved that are no longer in the shareholders' business focus or that are in difficulty, and which do not find other investors (companies in need of restructuring or with succession problems).

An intermediate form is the provision of replacement capital.

**1723.** So-called vulture funds are a class of private equity firms, or hedge funds in the alternative given their investment strategy, that have not been active in Germany for long. These firms have specialised in restructuring and divestment scenarios where they take advantage of a discrepancy between the inner economic value and the market value of the relevant undertakings. In such cases, the creditors (banks) usually coordinate their common strategy to implement the restructuring or the liquidation in a manner maintaining the company value to the largest extent possible. The financial investor can exploit the creditors' "burden of suffering" to, for instance, buy out the bank mostly affected with its claims, and to afterwards make the other creditors likewise transfer their claims to it (at a discount). When it has acquired control of the undertaking in that way, it can restructure it to enhance and tap the value potential, or it can liquidate it – as it can do where restructuring fails or is not possible – to the same purpose ("asset stripping")<sup>555</sup>.

**1724.** The private equity industry does not regard itself as being part of shadow banking. It maintains that private equity firms do not engage in credit intermediation because they invest equity capital. Though loans are used in private equity transactions, these loans are not taken up by the private equity firms, but by the portfolio undertakings and are secured with company collateral.<sup>556</sup> That being said, private equity firms invest funds that they have collected in a deposit-like manner in (closed) investment funds before. At least in the buy-out business, they regularly also use leverage by making

<sup>555</sup> The term "asset stripping" is actually used for all cases of an excessive depletion of assets, but it is mainly used for divestiture scenarios. In that context, capital conservation is protected particularly (§ 292 KABG).

<sup>556</sup> Cf. BVK, Beteiligungsgesellschaften sind keine Schattenbanken, [2011/12 ] Private Equity-Brief No. 16, pp. 1-2.

the acquired undertaking obtain credit to pay out to its former shareholders. In that context, it must be noted that the private equity firms regularly form an economic unit with the undertakings that they acquire. The relevant target undertakings can accept or refuse the whole transaction as it has been structured by the private equity firm, but they cannot influence the share of leverage.

**1725.** It is unclear whether private equity firms accumulate systemic risk in such a way that they themselves benefit from an implicit guarantee. That said, their investment behaviour is associated with risk that can create or strengthen an implicit guarantee for the equity or outside investors standing behind. For equity investors, the long capital lock-up in the funds can be problematic. In addition, the return is subject to much volatility depending on the year in which the funds have been launched (vintage year). Regarding the risks for outside investors, credit default risks may play a minor role due to the company collateral serving as credit insurance, yet reservation risks remain in so far as agreed loans are not being called, as well as liquidity risks and refinancing risks.<sup>557</sup> It remains to be seen whether the development of secondary trade in private equity investments will lower the market risk associated with private equity transactions in the longer run.<sup>558</sup>

### 3.7.2.2 Hedge funds

**1726.** Investment companies active in the hedge funds business use the same or similar organisms as private equity firms, but they pursue a different investment strategy. Here, the focus is not on any interest in the value of a company or of financial instruments as such, but on movements in market value. Originally, hedge funds fulfilled an insurance function by way of arbitrage operations. Nowadays, beside market-neutral strategies (arbitrage), hedge funds also use riskier opportunistic strategies or mixed forms. The classification is not uniform. In particular the following investment strategies are considered as being characteristic of hedge funds:

- Arbitrage (market neutral strategy): These strategies continue to be pursued, either with bonds (“fixed income arbitrage”) or with financial instruments connected to each other (“relative value arbitrage”), e.g., convertible bonds and the associated shares. In the case of “merger arbitrage”, the hedge fund buys or sells shares of the undertakings concerned in the context of company takeovers thereby, e.g., exploiting information advantages.
- Long-short strategies: These strategies are based on the exploitation of differences in price movements of two securities on the same market. Securities presumed to rise in market value are bought (“long”) and serve as securities for a parallel transaction. In this transaction, securities expected to drop in market value (“short”) are sold with the intention to repurchase them later at a lower price in order to hand them back to the original owner (short selling).
- Event-driven/global macro: These strategies are used to exploit market events or macroeconomic trends (e.g., in the case of currency speculation). The investment focus shifts depending on the opportunities and the fund manager’s appraisal. The strategies are risky.
- Equity market neutral: This strategy consists of investments into securities trailing behind the development of the industry. Also traditional equity funds use these strategies.
- Company crises (“distressed assets”/“securities”): In this case, the fund makes capital available to the owners of undervalued company assets or shares, exploiting that undervaluation.

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<sup>557</sup> Cf. London Economics, Non-bank Financial Institutions: Assessment of their Impact on the Stability of the Financial System, European Commission Economic Paper 472, November 2012, pp. 75-76. It is, however, still possible that credit default risks persist, e.g., in the form of collateralisation risks; see, e.g., Chediak, Energy Future’s Reduced Earnings to Sap Credit Recovery Values, Bloomberg, 18 October 2013.

<sup>558</sup> Cf. Paul, H., Zweithandel mit Private Equity blüht immer weiter auf, FAZ, 6 November 2013.

The profit chances of these strategies are raised through leverage. According to an older study, arbitrage and long-short equity account for roughly half of the funds' volume, the remaining volume being used for riskier strategies.<sup>559</sup>

**1727.** Investment companies in the hedge funds business are considered to be market participants with a riskier profile than private equity firms. Also in this case, investment companies invest funds previously collected in (closed) investment funds. The holding period, however, is short-term. In some cases, hedge funds use large amounts of funds that can be activated quickly. The investments partially take place in risky fields of business, the risk being increased through leverage and short sales. Thus, the investment strategies can have significant potential to destabilise the market and to threaten the hedge fund itself, its investors and even entire financial systems.<sup>560</sup> In view of the opacity of the hedge funds business, this destabilisation potential generally gives rise to concerns.

**1728.** The risks for financial stability are additionally raised through close links between the hedge funds business and the banking industry. American hedge funds – apart from other US asset managers and investment funds – belong to the companies that have bought the European banks' credit portfolios from the debt-ridden EU Member States and that invest considerably in the stock of European banks.<sup>561</sup> Thereby, the funds (and the investors standing behind) accept risks from the banking industry that are difficult to rate at the present time. Banks in turn provide services financial services to hedge funds in the context of prime brokerage<sup>562</sup> and counterparty relationships. These relationships make it possible that risks of the hedge funds business spill over to the relevant banks (as investors).<sup>563</sup> Moreover, hedge fund companies can withdraw collateral from the banks acting as their prime brokers if they lose confidence in the solvency of the banks, thereby weakening them additionally. Where banks interact with hedge funds as their counterparties, the distress of one party can moreover threaten the survival of the other party.

**1729.** The rescue of the LTCM hedge fund (1998) and of hedge funds active on the US market in the financial crisis (including bank hedge funds) have demonstrated that hedge fund companies themselves can be systemically relevant and can benefit from an implicit guarantee at least in a crisis scenario. Moreover, the interconnections with the banking sector can have the result that the banks' systemic importance increases and that the implicit guarantees to their benefit are reinforced, especially in periods of crisis.

### 3.7.2.3 Money market funds

**1730.** Money market funds are currently in the foreground of shadow banking regulation. The funds in the regulators' focus are US companies represented in the EU with subsidiaries in France, Ireland, and Luxembourg.<sup>564</sup> They are frequently funds organisms that are attached to an institutional investor (e.g., a bank, an insurance company) and that invest mainly in money market instruments and (other) liquid securities with short (remaining) time to maturity. Money market instruments securitise time deposits and other claims and have a duration of less than 397 days or bear interest that is adapted to

<sup>559</sup> Cf. broadly Böttger, C., *Strukturen und Strategien von Finanzinvestoren*, Hans-Böckler-Stiftung, Working Paper 120, March 2006, p. 59; now also: Cumming, D./Dai, N./Johan, S.A., *Hedge Fund Structure, Regulation, and Performance around the World*, 1st Ed. 2013, Section 6.3.1.

<sup>560</sup> See London Economics, *Non-bank Financial Institutions: Assessment of their Impact on the Stability of the Financial System*, supra, p. 86 (increasing risk due to the market concentration at established funds).

<sup>561</sup> Wigglesworth, R., *Funds' €60bn to buy European bank debt*, FT, 20 May 2012; Stothart, M./Foley, S., *US funds place big bets on euro bank recovery*, FT, 19 November 2013.

<sup>562</sup> Prime brokers are banks (particularly investment banks) that offer a bundle of services to hedge funds, e.g., loans and securities settlement services. The market is highly concentrated; see also para. 1631 above.

<sup>563</sup> The actual amount of those risks is unclear however; see, e.g., Kemmer, M., *Zur Abtrennung von Kreditgeschäften*, FAZ, 20 April 2013: hedge funds deposit high-quality collateral.

<sup>564</sup> Cf. ESRB, *Recommendation ESRB/2012/1 of 20 December 2012 on money market funds*, Section III.

market conditions according to the terms of issuance regularly over the entire duration or at least once in 397 days.<sup>565</sup> On the average, money market funds are considerably larger than other investment funds, European money market funds managing assets in the amount of at least approximately EUR 1 trillion (= EUR 1,000,000,000,000).<sup>566</sup>

**1731.** Money market funds are open to institutional investors (e.g., banks, insurance companies), but they also provide opportunities for consumers to participate in money market transactions. The funds engage in maturity transformation by reinvesting collected funds that accrue interest. A characteristic feature of money market funds is that the funds do not have a residual term and that investors can consequently withdraw their money quickly.<sup>567</sup> To prevent the funds from “bleeding out” through panic sales, money market funds must continuously take care that the Net Asset Value (NAV) per issued share does not drop below a given value (e.g., \$ 1; “breaking the buck”). A variation popular especially with US funds are funds with constant NAV (CNAV) that guarantee a repurchase price set in advance.

**1732.** Still, the investors withdrawing first from a fund in the event of a fund crisis have important first mover advantages. Traditionally, the assets held in the investment fund are valued only at amortised cost and not at market prices, but they must be repurchased at market value when many investors withdraw. In this case, the fund assets dwindle to the detriment of the remaining investors. Therefore, money market funds bear a substantial risk of runs. This risk is not only associated with bad investments of the relevant fund, but runs can also be caused through market disturbances leading to the withdrawal of counterparties and, thus, to the drying up of money markets (feedback loops). Events of this type also caused the distress of several money market funds in the financial crisis (as buyers of ABCPs<sup>568</sup>).

**1733.** The risk that the value of value of money market funds plummets also falls back on banks as the funds main sponsors and investors or their business partners.<sup>569</sup> Thus, banks can be forced to acquire shares in the funds at NAV to support the funds and, consequently, to internalise market risks. Where a fund retains short-dated money market instruments to pay out investors, this can entail liquidity and price risks for longer-dated instruments. If the money market fund reduces its activities, this can increase the refinancing risk for the banks.<sup>570</sup>

#### 3.7.2.4 Other organisms and investors

**1734.** Beside the organisms described so far, many other funds organisms are active on the financial markets. The business of these organisms is often already captured by bank and securities regulation, but they sometimes also use novel financial instruments not yet captured by regulation (e.g., credit hedge funds, Exchange Traded Funds – ETFs<sup>571</sup>). In addition, other organisms and companies with

<sup>565</sup> Cf. § 194 KAGB, Article 2(1) lit. o, 50 and Recital 36 of Directive 2009/65/EC. Typical money market instruments include, e.g., treasury bonds without interest, cash certificates of the *Bund*, Commercial Papers (CP), and deposits certificates.

<sup>566</sup> European Commission, Proposal 4 September 2013 for a Regulation of the European Parliament and the Council on money market funds, COM(2013) 615 final, p. 2.

<sup>567</sup> A similar risk was made out for Exchange Traded Funds (ETF) given their fast growth; see FSB, Potential Financial Stability Issues Arising from Recent Trends in Exchange-Traded Funds (ETFs), 12 April 2011. Critically, e.g.: BVI, position paper of 20 March 2013, p. 4. As to ETF, see moreover ESMA, Guidelines of 18 December 2012 on ETFs and other UCITS issues, Dok. 2012/1832.

<sup>568</sup> ABCP = Asset Backed Commercial Paper (structured money market securities).

<sup>569</sup> Banks account for the largest part by far (85%) of the financial instruments issued as money market fund securities; European Commission, Proposal for a Regulation of the European Parliament and the Council on money market funds, *supra*, p. 3.

<sup>570</sup> Cf. London Economics, Non-bank Financial Institutions: Assessment of their Impact on the Stability of the Financial System, *supra*, p. 66.

<sup>571</sup> Exchange Traded Funds are exchange-traded index funds.

near-bank activities exist (e.g., broker-dealers, other financial companies).<sup>572</sup> It stands to reason that implicit guarantees for banks can increase also when these organisms act for banks as their sponsors, investors, or business partners. Additionally, the conduct of other investors withdrawing rashly from the financial markets during a crisis can threaten systemic stability, thereby creating or strengthening implicit guarantees (for banks and non-banks).<sup>573</sup> However, to what extent this is actually the case cannot be said based on the information available.

### 3.7.3 *Regulatory arbitrage through shadow banks*

**1735.** Current regulation to contain the implicit guarantees for banks can entail a risk of regulatory arbitrage as a follow-on problem. The organisms and investors attributed to the shadow banking industry (also pension funds, insurance companies) engage on the financial markets similar to banks by raising funds with deposit-like characteristics and re-investing them afterwards. Investors can target their investments to the financial products of these players to achieve higher returns in the non or less regulated arena.

**1736.** A risk of regulatory arbitrage is perceived particularly in that investors may shift funds from banks into alternative investment organisms or in non-European investment funds. These organisms are subject to regulation tied to their management and the relations between the organisms and banks (as capital investors).<sup>574</sup> The organisms themselves (i.e., the funds), however, are still subject only to national rules. This is meant to accommodate the substantial regulatory differences in the EU and the major significance also of foreign alternative investment funds. So far, however, national regulation does not fully contain the risks described in the previous sections.<sup>575</sup> Additional risks follow from the potential systemic importance of non-bank investors that are not subject to any regulation comparable to banking regulation.

**1737.** In fact, the European banks increasingly compete with the suppliers of alternative funds (e.g., insurance companies) in their investment business, also with foreign suppliers.<sup>576</sup> It is possible to make out a trend mostly towards riskier investments. It must, however, be taken into account that the central banks' low-interest strategy also creates substantial incentives to invest in risky assets (with relatively high interest). Moreover, even where there is evidence of market changes brought about by the regulation, those changes do not necessarily reflect regulatory arbitrage. For example, the capital rules under Basel III have raised the banks' liquidity cost, which means that the business of commercial real property financing shifts to a large extent to the credit funds of insurance companies and other market players. However, not the low regulation of the suppliers of alternative real property financing seems to explain this shift, but rather changes in the banks' business models and the abolition of regulatory advantages that banks ere traditionally enjoyed in competition by being able to shift risks out of their balance sheets by means of securitisation.<sup>577</sup> In contrast, the current growth of

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<sup>572</sup> Cf. FSB, Strengthening Oversight and Regulation of Shadow Banking. A Policy Framework for Strengthening Oversight and Regulation of Shadow Banking Entities, Consultative Document, 18 November 2012, pp. 1, 5-6.

<sup>573</sup> This means that also pension funds and insurance companies may profit from implicit guarantees; see FSB, Global systemically important insurers (G-SIIs) and the policy measures that will apply to them, 18 July 2013 (as to insurance companies). Sovereign wealth funds profit from explicit support of the States standing behind.

<sup>574</sup> See, particularly, Directive 2011/61/EU on Alternative Investment Fund Managers, OJ L 174, 1 July 2011, p. 1, transposed in Germany through Kapitalanlagegesetzbuch of 4 July 2013, BGBl. I 2013 No. 58, p. 3642.

<sup>575</sup> Nothing different follows from the fact that some Member States already have important rules in place to reduce these risks, e.g., Germany with regard to the valuation of the assets held by money market funds and regarding liquidity control (§§ 30, 168, 194 KAGB); now, see also Articles 26 ff. of the European Commission Proposal of 4 September 2013 for a Regulation on money market funds.

<sup>576</sup> Deutsche Bundesbank, Aktuelle Entwicklungen am Markt für Investmentfonds: Nachfrage, Strukturveränderungen und Anlageverhalten, Monthly Report, January 2013, pp. 13-28.

<sup>577</sup> Since banks could use structured instruments to shift risks out of the balance before the reform of the capital

asset management firms acting as hedge fund sponsors seems to be explained by the fact that banks withdraw from the trade in defaulted bonds and the arbitrage in fixed-interest values due to the tightened capital regulation, which does not apply to alternative suppliers. In that regard, hence, there are indications of regulatory arbitrage. Nevertheless, it would not be possible to make a general estimate beyond the individual case as to the degree of regulatory arbitrage currently actually taking place by way of a shift of business due to competition-distorting regulation.

**1738.** Banks can also engage in regulatory arbitrage themselves and of their own account in order to shift risks from the regulated area into the non-regulated area.<sup>578</sup> This shift of risk can have the result that the implicit guarantees existing for the investors (banks, etc.) are strengthened indirectly through the organisms that accept the relevant risk.

### ***3.7.4 Regulatory proposals made to date: steps in the right direction***

**1739.** With a mandate of the G-20 (summit of November 2010), the Financial Stability Board (FSB) and the International Organization of Securities Commissions (IOSCO) have meanwhile worked out their first recommendations on the regulation of shadow banks and shadow banking activities. These recommendations include a first framework approach (high-level policy framework) allowing the competent authorities to rein in the problem areas requiring regulation. In addition, principles were defined to determine and monitor risks (especially through disclosure obligations), and a “policy toolkit” for potential measures. These measures aim at the limitation of risk and address fund organisms (given the risk of runs), business models based on short-dated funding or collateral for the funding investors, measures to increase credit supply (e.g., default insurance), and the use of ABS. More detailed recommendations relate to money market funds, which should be explicitly defined by law, and subjected to restrictions in relation to their investments and the acceptance of risk and tighter risk management rules (rating requirements, external accounting, liquidity requirements, transparency obligations, etc.). To the extent possible, CNAV organisms should be transformed into organisms without constant NAV.

**1740.** The recommendations mentioned above have already partially been implemented in the EU. A number of – in part very detailed – rules are already in place for the management of closed funds and for open funds.<sup>579</sup> In addition, banking regulation imposes conditions on the use of SIV and on investments in funds organisms. The European Commission made proposals on the further development of the existing regulation in its Green Paper and the subsequent Communication on shadow banking.<sup>580</sup> Moreover, it has submitted a proposal for a Regulation on the regulation of money market funds and a consultation document on a possible framework for the recovery and resolution of financial institutions other than banks.<sup>581</sup> The proposal for a Regulation on money market funds is in

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rules, it is likely that the banks actually only lost a competitive advantage induced by regulation in the area of real property financing; see Flatow, C.-C., *Die Zukunft des gewerblichen Immobilienfinanzierungsmarkts*, [2013] *Immobilien & Finanzierung* 4, p. 120 (121).

<sup>578</sup> An example may be capital relief trades, which European banks have used increasingly in recent years to transfer risks from the balance sheet to alternative investors. As to these trades – which resemble the US sub-prime transactions in view of their structure – see, e.g., Alloway, T., Big banks seek regulatory capital trades, FT, 29 April 2012; Kahn, J./Vaughan, L., New capital rules spur banks seek breathing room with controversial credit relief trades, Washington Post, 20 September 2013.

<sup>579</sup> See, e.g., Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), most recently amended by Directive [...]/2014, preliminary version of the legislative resolution of the European Parliament of 15 April 2014, P7\_TA-PROV(2014)0355; Directive 2011/61/EU on Alternative Investment Fund Managers (AIFM), most recently amended by Directive 2013/14/EU, OJ L 145, 31 May 2013, p. 1.

<sup>580</sup> European Commission, Green Paper, Shadow banking, COM(2012) 102 final, 19 March 2012; European Commission, Communication from the Commission to the Council and the European Parliament, Shadow Banking – Addressing new sources of risk in the financial sector, COM(2013)614 final, 4 September 2013.

<sup>581</sup> European Commission, Proposal 4 September 2013 for a Regulation of the European Parliament and the

line with the IOSCO recommendations and contains strict requirements in particular for funds with constant NAV (especially liquidity buffers of 3% of the total value of assets). From an industry perspective, the proposed rules threaten directly the existence of CNAV funds – not least given the current low-risk environment – and one must consequently wait to see to what extent they will be included in the final Regulation. A still open regulatory flank could result from the still possible and popular use of risk measures such as “value at risk”. These risk measures are prone to criticism because they have substantially underestimated systemic risk so far.<sup>582</sup> Also in that respect, however, regulatory improvements have taken place with still unknown effects.<sup>583</sup>

**1741.** The German legislature has equally tightened the regulation of the organisms attributed to the shadow banking industry. In that context, reference is made notably to the Capital Investment Code (Kapitalanlagegesetzbuch – KAGB) of 4 July 2013.<sup>584</sup> In part, the German provisions go beyond the underlying EU Directives. For example, the German statute captures the relevant types of funds based on more detailed categories and limits, for instance, the possibility for public AIF (Publikums-AIF) to invest in so-called special AIF (Spezial-AIF) (§ 219 KAGB). In view of the so-called European Pass for funds organisms, however, it must be avoided that it is possible to circumvent German rules that are tighter than EU law by establishing potentially affected funds organisms in other EU Member States.<sup>585</sup> This problem has to be kept in mind in the future national legislative efforts.

**1742.** All in all, the Monopolies Commission welcomes the regulatory proposals so far. It can be presumed that the intended regulation will contribute effectively to the neutralisation of implicit guarantees both in the banking and the non-banking industry. Still, the further regulatory steps in the shadow banking sector pose significant challenges. It will be foremost important, as a preparatory step, to improve the data base, to which the trade repositories can make an important contribution. To the extent possible, the individual regulatory measures should be coordinated at the European level or even internationally as they should mostly relate to supra-national markets. There are not many clear indications so far that rules distorting competition exist which give rise to regulatory arbitrage, but still, this risk is undeniable.<sup>586</sup> Therefore, the Monopolies Commission advocates accuracy instead of speed in the creation of additional rules. Also with respect to possible additional rules on the national level, it points out the need for thorough impact assessments.

### ***3.8 Developing regulation further in the medium and longer term***

**1743.** In the Monopolies Commission’s view, the regulatory framework evaluated in the previous sections is suitable and necessary to decrease the systemic distortions of competition resulting from implicit guarantees. When this regulatory framework is developed further, however, also the current competitive conditions on the financial markets and the risks for the medium- and long-term development of the affected markets must be considered. The Monopolies Commission recommends politicians to use the existing leeway to counteract any one-sided regulatory preference for capital-market based corporate financing if regulation gives rise to unjustified disadvantages in competition

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Council on money market funds, COM(2013) 615 final; Consultation on a possible recovery and resolution framework for financial institutions other than banks, accompanying document of 5 October 2012; [http://ec.europa.eu/internal\\_market/consultations/2012/nonbanks\\_en.htm](http://ec.europa.eu/internal_market/consultations/2012/nonbanks_en.htm); accessed: 24 June 2014.

<sup>582</sup> Cf. Gropp, R., How Important Are Hedge Funds in a Crisis?, FRBSF Economic Letter 11/2014 bzw. SAFE Policy Letter No. 23, 14. bzw. 28. April 2014; Riedel, F. in Heinrich, G., Ein Modell bringt das Finanzsystem ins Wanken, *Finanzen100*, 25. March 2014.

<sup>583</sup> See Articles 364 ff., 383 V of Regulation 575/2013; in addition, also indirect factors must be taken into account (e.g., the introduction of CCP).

<sup>584</sup> Kapitalanlagegesetzbuch of 4 July 2013, BGBl. I No. 35, p. 1981; meanwhile with amendments.

<sup>585</sup> See Articles 6 ff. of Directive 85/611/EWG (OGAW); Article 8(1), last sentence, of Directive 2011/61/EU (AIFM) and § 24 KAGB in German law as to the EU Pass.

<sup>586</sup> Another problem consists in the risk of over-regulating particularly small suppliers. See Section 3.8.1 below in that regard.

for smaller institutions. The international convergence of regulation must be strengthened to improve the competitiveness of the European financial markets and to work against further fragmentation of the financial markets.

### ***3.8.1 Avoiding and reducing distortions of competition due to unbalanced regulatory burdens***

**1744.** Banking and financial market regulation following the crisis has brought about substantial interventions with the existing market structure. This can be justified because and to the extent that regulation is intended to do away with risks to stability and the existing distortions of competition through implicit guarantees. Regulation itself, however, has a major impact on the markets. According to one study, German banks attach more significance to regulatory effects on their medium-term success in business operations than new competitors, customer behaviour, or margin pressure.<sup>587</sup>

**1745.** From a competition policy perspective, the main objective of regulation must generally be the creation of equal framework conditions for different funding options. Current regulation, however, sometimes leads to diverging competitive conditions that may contribute to substantial changes in the financial system in the medium or long run. In the view of market participants, the following aspects are the most serious:

- First, regulation is mainly adjusted to the needs of corporate finance. In this context, there is a tendency to favour capital-market based financing methods over credit-based financing.
- Second, also the regulation of the capital market business is unbalanced because it puts individual market participants and products at a disadvantage irrespective of their risk potential.
- Third, regulation places a particular burden on smaller market participants, both because of the adjustment to capital-market oriented business models and the substantial weight of regulation.

To the extent that regulation puts a particularly strenuous burden on small institutions with traditional deposits and loan operations, a development continues that could already be seen before the turn of the millennium.<sup>588</sup> According to industry representatives, current regulation altogether does not observe the intended double proportionality.

**1746.** The fact that regulation is oriented towards the needs of corporate finance can be explained with the objective of remedying the impairments of the single financial market. In this respect, furthering capital market activities suggests itself to establish capital-market based types of funding to a larger extent as a complement to credit-based funding on the continental European markets. The capital markets are oriented across frontiers and very liquid as compared with the credit and loan markets, meaning that capital-market financing can make an important contribution to the restoration of the single financial market. In addition, credit relationships always entail the risk of contagion. It is hardly possible to estimate the impact that such risks may have on the single financial market in their totality. According to studies, however, credit-based connections explain the contagion effects observed in the financial crisis and the serious effects of the crisis to a major extent.<sup>589</sup>

**1747.** That being said, the risk exists that regulation promoting the capital market business may entail unjustified disadvantages for the credit business, namely in so far as the latter business is actually

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<sup>587</sup> Cf. KPMG, *Auswirkungen regulatorischer Anforderungen*, study of December 2013, pp. 10, 14 ff.

<sup>588</sup> Detailed Hammerschmidt, R., *Wettbewerbsverzerrungen im Bankenmarkt* 1st Ed., Baden-Baden 2000.

<sup>589</sup> Cf. Feldkircher, M., *The Determinants of Vulnerability to the Global Financial Crisis 2008 to 2009*. *Credit Growth and Other Sources of Risk*, [2014] *Journal of International Money and Finance* No. 43, pp. 19-49.

stable and relatively resistant to crises. This should hold in particular for the business of smaller institutions (e.g., private regional banks, savings banks, local cooperative banks). The business of the banks is commonly based on long-term business relationships and a good understanding of the local conditions, implying that a particularly broad information base exists to evaluate the financial situation of the clients. In addition, the customers of those banks mostly use the credit in a market context that is easier to assess than in the case of large corporate customers.

**1748.** That the capital market business is preferred can be seen particularly in capital regulation, which tends to privilege trading book positions towards positions in the banking book. This does not seem to be completely innocuous given that apparently two thirds of the net losses in the crisis had to be attributed to trading book positions.<sup>590</sup> It is true that the risk weights for trading book positions pursuant to Basel III were increased for trading book positions. However, also the traditional credit business has been subjected to considerably higher capital requirements, and this also includes, for example, requirements for SME loans that did not cause any problems during the financial crisis. With regard to more complex products in the capital market business, the risk weights seem to be rather low.

**1749.** The liquidity requirements likewise privilege capital market investments (securities investments) over direct credit provision. For example, it is planned in the context of the long-term funding benchmark NSFR to tie loan maturities to the maturities of existing deposits or funding. In this context, corporate bonds are charged at 0% or 50% towards the necessary long-term funding whereas, for example, an SME loan is charged at 85% or 100% depending on its maturity.

**1750.** Within the rules on financial instruments traded on the capital markets, however, other imbalances exist according to the market participants. These imbalances result from distinctions that the law makes with regard to both the regulated undertakings and product regulation. Regarding the regulated undertakings, reference may be made, for instance, to the disadvantages that investment companies face in German law according to association statements (e.g., regarding the issuing and financial commission business, in relation to the investor protection rules).<sup>591</sup> Regarding the products, competition is distorted particularly because the various means of funding suffer from unequal treatment, meaning that, for example, sovereign bonds are privileged over covered bonds and that particularly ABS (especially RMBS<sup>592</sup>) are at a disadvantage. Sovereign bonds, in contrast to covered bonds, are weighted with 0% although they entail a risk of default and their market value can be exposed to massive fluctuation.<sup>593</sup> In the view of market participants, ABS are disadvantaged to a particular large extent both through regulation and as repo collateral. ABS can be used for similar purposes as covered bonds as they are bonds as well that are covered through the claims and the underlying collateral. That said, ABS broaden the collateral stock used for covered bonds by allowing the use of other risks as collateral that would otherwise not be marketable (= illiquid). Instead of the ceiling for covered bonds, ABS subordinate the securitised claims in a certain order. Since, in the case of ABS, the originator of the ABS is not itself liable, the asset pool is much more important.

**1751.** The disadvantages for investment companies should be related to the interest to protect the domestic universal banks against competitors with an Anglo-Saxon business model. In that regard, however, they run counter to the objective of creating a single European financial market. The disadvantages for ABS may be explained with the experience of the financial crisis. That does not necessarily imply, though, that they are justified in substance as the risks materialising in the crisis

<sup>590</sup> Cf. Erlebach, J./Grasshoff, G./Berg, T., Die Effekte von Basel III, [2010] Die Bank 10, 54 (survey of the ex-post losses of 150 banks in the EU-15, Switzerland, and North America).

<sup>591</sup> Corresponding to the distinction between credit institutions and investment firms in EU law, German law distinguishes between deposit credit institutions (*Einlagenkreditinstitute*) and financial service institutions (*Finanzdienstleistungsinstitute*) or securities trading banks (*Wertpapierhandelsbanken*); see § 1 KWG.

<sup>592</sup> RMBS = Residential Mortgage Backed Securities.

<sup>593</sup> See Section 5.6.2 below regarding this issue.

were less related to the technique of securitisation and more to the securitised risks and product and market opacity. In contrast to US sub-prime securities, particularly German ABS products survived the crisis also quite successfully. Continually disadvantaging ABS entails the risk that it will threaten the economic recovery after the abatement of the European financial and economic crisis.<sup>594</sup> That being said, the ECB has started a to-be-welcomed initiative to revitalise the ABS market.<sup>595</sup>

**1752.** The regulatory imbalances disadvantage individual market participants and, according to many industry representatives, in particular smaller institutions concentrating primarily on the traditional deposits and loan business and having only little capital market activities. Added to this must be the complexity and latitude of regulation, which puts all smaller financial market participants (banks and non-banks) at a disadvantage.

According to industry representatives, in particular the capital rules are a burden on smaller banks that is excessive and weakens them in competition. For example, smaller institutions are generally not able from the outset to use internal risk models, which means that these institutions cannot benefit from the frequently lower risk weights of the Internal Ratings Based Approach (IRB Approach).<sup>596</sup> Criticism is also made of how claims are classified as “mass market” business, a class central for smaller banks, because the classification is said to be to the advantage of the large banks. Generally, the high complexity of regulation is a problem because it raises the fixed costs, which is a burden particularly for smaller banks – notably if these banks cannot take recourse to common resources within the framework of an associated group.

According to industry representatives, the heavy burden of regulation nowadays also hits, for instance, small suppliers of funds and alternative investments.<sup>597</sup> Thus, the problem goes beyond the banking sector.

**1753.** A likely consequence of these regulatory disadvantages is that smaller banks and suppliers of capital investments are weakened in competition and withdraw from business areas where they have only limited activities in order to avoid regulatory costs. Such a development would be problematic as smaller market participants do not necessarily engage in riskier activities and as the openness of the markets also for niche players is indispensable for the development of undistorted competition. Because of their business model oriented towards local supply and their presence across all regions, the smaller members of the associated groups (savings banks, cooperative banks) have a stabilising function within the German financial system. Were the smaller market participants to withdraw from individual business areas, this would moreover tend to strengthen the market power of large market participants. This would be a factor that would allow these institutions to absorb a larger volume of business, which could also entail more concentration of risk at the large market participants and, thus, strengthen their systemic relevance in the long run. Such a development would be of concern from both a stability and a competition perspective.

**1754.** The Monopolies Commission recommends politicians to use the available scope of action to counter one-sided regulatory privileges for capital-market corporate finance in so far as such privileges entail unjustified regulatory disadvantages particularly for smaller institutions. In that context, regulation should be reviewed with respect to the individual means of funding (especially

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<sup>594</sup> Cf. Papadia, [2011] ZfgK 999 (1002-1003); Meisner/Renner, [2012] ZfgK 934 ff.; Marsh, A., Verschärfung der ABS-Konditionen birgt Risiken für Europa, *Die Welt*, 20 September 2013.

<sup>595</sup> In addition, also the newly foreseen NSFR should make ABS more attractive.

<sup>596</sup> Cf. Articles 142 ff. of Regulation 575/2013, OJ L 176, 27 June 2013, p. 1.

<sup>597</sup> Thus, according to association submissions, there are already indications for regulation-induced concentration at private equity and funds companies; see also Hiller von Gaertringen, C., *Regulierung beeinflusst Wettbewerb*, FAZ, 26 October 2013 in that regard. As to the regulatory burdens on small banks, see Section 3.8.1 below.

sovereign bonds, covered bonds, ABS). It should also be advisable to create additional incentives to reduce the complexity of structured products (in particular, with regard to multiple securitisations).

In addition, the Monopolies Commission recommends the competent authorities to closely monitor the financial markets with regard to the effects of regulation, particularly in the context of the supervisory dialogue and their general supervisory support. Should this not be sufficient from the affected banks' perspective, it might be considered to have representatives of the supervisory authorities present at voluntarily cooperating banks for an adequate time period to oversee the implementation of the regulation.

Lastly, the Monopolies Commission welcomes the initiative from the European Parliament at the end of 2013 to evaluate the effectiveness of the existing regulation before taking additional regulatory steps (impact assessment).<sup>598</sup> At least some time after the implementation of the essential regulation, the effects of all newly introduced rules should be reviewed to identify and abolish superfluous and excessively burdensome provisions.

### ***3.8.2 Protecting the competitiveness of the German and European market participants***

**1755.** The evolution of regulation must also take account of the fact that some financial markets reach beyond EU borders (global markets) or that European institutions are active also in national markets outside the EU. In that regard, it is necessary to exclude unjustified impairments of the domestic financial market participants' competitiveness to the extent that this is possible. In that context, attention must be paid to the fact that an abolition of implicit guarantees constitutes a direct competitive disadvantage vis-à-vis competitors that continue to benefit from such an implicit guarantee.

**1756.** Maintaining the competitiveness of the European banks is particularly important in relation to institutions from the United States to which the European economy has the strongest financial ties outside the EU. To what extent the competitive issue mentioned above exists in relation to the United States is difficult to tell given the contradictory and frequently biased information about the implicit guarantees of and the regulatory burden on US banks. In the media, the US banking sector is frequently described as fraught with fewer problems than the European banking sector.

**1757.** When one comments on the competitiveness of European and American institutions by comparison, a distinction is necessary between the measures first adopted to cope with the financial crisis and the regulatory re-design of the financial system with a view to the future. According to the information available, the United States managed particularly well to contain the financial crisis vis-à-vis their domestic institutions and to finally overcome the crisis. The locally active banks were subjected to stabilising State intervention to a larger extent than in particular most affected European banks. However, this State intervention – which was limited in time – enabled the American banks to quickly generate new business and thus allowing them to reduce their legacy problems.<sup>599</sup> In contrast, the German banks probably harmed themselves by not using the possibilities created for strengthening

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<sup>598</sup> Vice President Karas, European Parliament, as quoted in: Osman, Y., Zu viel – und zu komplex, Handelsblatt, 6 November 2013. The European Commission submitted a very first Impact Assessment on 15 May 2014, underlining its preliminary character, though; see European Commission, Commission Staff Working Document, Economic Review of the Financial Regulation Agenda, SWD(2014) 158 final, 15 May 2014. Such impact assessments are at least partially ensured through clauses in the new legislation, which provide for the regular review of the respective rules.

<sup>599</sup> See Grasshoff, G. et al., Global Risk 2013-2014: Breaching the Next Banking Barrier, The Boston Consulting Group, 19 November 2013, pp. 5 ff.; moreover Joyce, J.P., Bank Lending: Too Much of a Good Thing?, EconoMonitor, 17 March 2014 on the US support benefiting European banks. Pursuant to Dodd-Frank Act (Section 214), US banks may legally no longer be supported by the State.

their capital base under the Financial Market Stabilisation Act (*Finanzmarktstabilisierungsgesetz*) of 2008.

**1758.** That being said, there are still a number of international banks active in the United States that continue to benefit from higher implicit guarantees than their European competitors. Thus, systemically relevant banks were merged to stabilise them in the crisis, which should rather have increased the systemic importance of the surviving entities.<sup>600</sup> The five largest US banking groups control assets today in the amount of more than half of US GDP.<sup>601</sup> In addition, measured by risk weights under Basel II, the US banks control assets with considerably higher risk than their European competitors on average.

**1759.** The increasing regulation also on the US side appears not to have altered this situation significantly. The possibility to resolve a large US bank under the resolution rules of the Dodd-Frank Act is viewed rather sceptically, and the same holds for the effects of the so-called Volcker Rule on the separation and abolition of proprietary trade.<sup>602</sup> The supervisory authorities are able to assess the risks associated with derivatives only to a very limited extent, which should be due not least to the fact that US accounting standards continue to allow the banks using them to net derivative positions to a much larger extent than is possible under the traditional European accounting standards. Moreover, the risk reporting of large international banks is difficult to understand from the outside.<sup>603</sup>

**1760.** In the long run, reducing the competitive disadvantages for European banks should only be possible through more international regulatory convergence. In the meantime, the US regulators' approach must be welcomed to subject non-domestic banks to strict capital requirements in order to ensure that sufficient capital buffers exist in view of the systemic threats which these banks pose to the financial market in the United States. The Monopolies Commission recommends the same approach for the EU.

### ***3.8.3 Countering the continued fragmentation of the financial markets***

**1761.** The Monopolies Commission is lastly concerned by the increasing fragmentation of European and worldwide financial markets. In the financial crisis, many European banks withdrew to their domestic markets, partly to concentrate voluntarily on their domestic business, partly because they had agreed to such limitations as compensation for State aid. The regulation to contain the crisis has contributed to further fragmentation of the financial markets in some areas at least temporarily. When this regulation is developed further, the interests of individual States and the interests relevant across borders must be brought into a balanced relationship, both at the European and at the international level.

**1762.** At EU level, stabilising the financial markets and alleviating the burden of continued liability risk for the taxpayers in Member States have been the main drivers so far. There has been an interest to improve the general conditions as fast as possible to limit the risks as much as possible if the crisis were to return. Thus, arguments existed for individual Member States to go ahead with regulation, an option that several Member States – not least Germany – have used particularly with rules popular

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<sup>600</sup> While the American Federal Deposit Insurance Corporation (FDIC) opened resolution proceedings at 465 banks from 2008 to 2012, these proceedings related primarily to smaller institutions that should not have been systemically relevant. See Council of Economic Experts, *Gegen eine rückwärtsgewandte Wirtschaftspolitik*, supra, para. 367.

<sup>601</sup> Cf. Hoenig, T.M., speech at the National Association for Business Economics, supra.

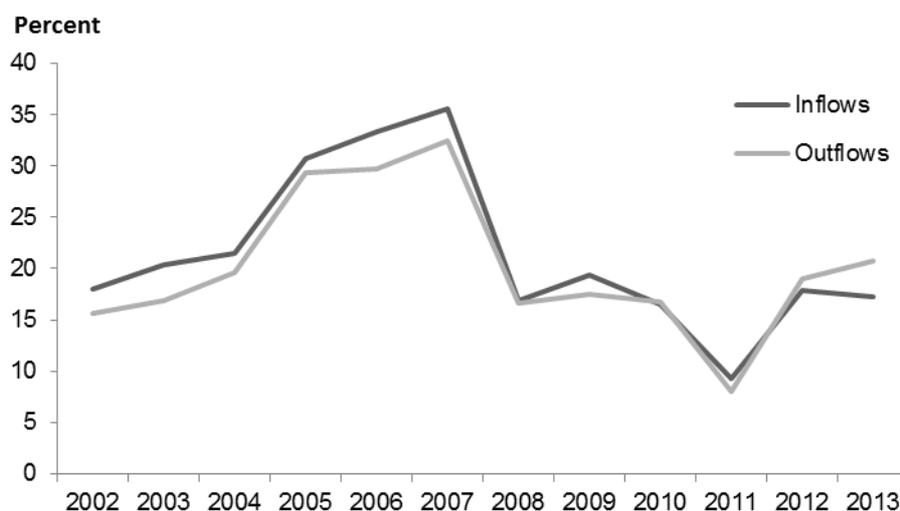
<sup>602</sup> Cf. Johnson, S., *The Myth of a Perfect Orderly Liquidation Authority for Big Banks*, *Economix Blog*, NY Times, 16 May 2013; Easton, R., *The Volcker Rule: Hedge-trimming*, *The Economist*, 14 December 2013.

<sup>603</sup> However, the latter also holds for European institutions; see Hartmann, W., *Risikotransparenz von Banken bleibt undurchsichtig*, *Börsen-Zeitung*, 18 April 2014 (as to the reporting of large EU and US banks).

with the voters (key words: dual banking laws, financial transaction tax). This came, however, at the price of a risk that continued uncoordinated regulation could further increase the fragmentation of the financial markets and cause lasting damage to the natural evolution of the single financial market in the EU.

**1763.** In fact, the amount of cross-border financial activities in the EU has decreased in the years since the financial crisis erupted (see Illustration VI.5).

**Illustration 5: Cross-border financial flows in the euro area (intra and extra in- and outflows in percent of the GDP)**



Sources: Own calculation and illustration. Concerning the data, see International Monetary Fund (IMF), <http://dsbb.imf.org/Pages/SDDS/CtgCtyList.aspx?catcode=BOP00&catname=Balance+of+payments>, accessed 7 May 2014. Cross-border financial capital flows encompass all transactions between a Member State and a non-Member State of the euro area as well as between the Member States of the euro area. Financial capital flows encompass transactions differentiated according to the inflows and outflows into or from a Member State of the euro area, concerning direct investments, securities investments, financial derivatives, other investments, and currency reserves; see, for example, ECB, euro area cross-border financial flows, Monthly Bulletin, February 2012, S. 110. Data on transactions and on the GDP were successively increased with regard to new Member States acceding to the currency area (variable composition).

**1764.** Continued fragmentation of the single financial market becomes less likely when the banking union is created, primarily among the Member States of the euro area, and through the development of a (single regulatory framework (“single rulebook”) and the farther-reaching harmonisation of prudential rules. The supervisory standards in the EU have been harmonised in many areas in the meantime. The amount of special national regulation tends to decrease. In many areas, EU regulation was the first regulation to create uniform or at least comparable competitive conditions. Thus, the problem of financial market fragmentation should lessen within the EU.

**1765.** On the international level, however, there is a risk that the fragmentation of the financial markets will continue to exist or even increase and, thus, put obstacles to the efforts to reduce implicit guarantees. In that context, it should be considered that the systemically relevant banks and other financial market participants so far the focus of State measures are regularly active on cross-border markets. Under these conditions, non-coordinated regulation increases on the one hand the work and costs for the affected firms and may on the other hand favour the concentration of risk in individual regions, this leading to an overall increase in systemic risk. Such a development is currently looming, palpably due to the still not coordinated conditions for the admission of EU and US undertakings

providing essential market infrastructures, particularly Multilateral Trading Facilities (MTF).<sup>604</sup> Apart from the aforementioned risks, the international enforcement of the relevant rules encounters difficulties or regulatory arbitrage takes place.<sup>605</sup> In the worst case, financial services are no longer offered because of inconsistent or incoherent regulation even though those services are in demand.

**1766.** The reform of worldwide financial market regulation has stalled partly in the meantime. In contrast, the global systemic importance of some institutions active worldwide has even increased.<sup>606</sup> With the crisis abating, continuing the reform process becomes increasingly difficult as politicians in the home countries of foreign institutions of global systemic importance may not have sufficient incentives to reduce the systemic importance of the relevant banks.

**1767.** Against this background, the Monopolies Commission welcomes the Federal Government's general determination to continue to play a leading role in the development of regulatory concepts, and to promote the continued reform of the financial markets internationally. Nevertheless, it takes a critical position towards individual national advances in the future development of rules to address the problem of systemically induced distortions of competition. Such individual advances should only be justifiable if they concern measures that contribute to the direct neutralisation of implicit guarantees (e.g., through increased capital buffers, security systems).<sup>607</sup>

### **3.9 Intermediate result**

**1768.** The Monopolies Commission acknowledges that German policy has made important contributions to the stabilisation of the European financial system since the outbreak of the financial crisis and that it has countered fiscally dubious efforts to make taxpayers also pay for the bank liabilities in other Member States. At this point, it considers that the right moment has come to rebalance these short-term objectives with the longer-term objectives of competition policy.

**1769.** The systemic risks revealed in the financial crisis are related to systemic distortions of competition. Individual banks (and other financial market participants) can benefit from an implicit State guarantee if other market participants consider them to be systemically relevant due to the accumulation of risk and if they consequently can no longer be permitted to leave the market (= guarantee of survival). The financial crisis has shown that this implicit guarantee constitutes a competitive advantage. So far, this advantage has not been absorbed under national law. That said, the European Commission required compensation not only for State aid rendered, but also for the implicit guarantee of survival in its decisions on the bank rescue aid paid during the crisis.

**1770.** More recent banking regulation is supposed to prevent State aid from having to be rendered again because implicit guarantees are being called upon. It is meant to neutralise the existing implicit guarantees and to hinder the new accumulation of risk that leads to such guarantees.

**1771.** As the probably most effective means of neutralising implicit guarantees, the Monopolies Commission favours the establishment of a resolution mechanism. In this regard, an important first step has now been taken both at EU level and at national level. The close connection with the rules on EU State aid proceedings appears noteworthy as a positive feature. The resolution mechanism will however only be effective if, when the next crisis breaks out, sufficient sources of finance capitalised

<sup>604</sup> Cf. the negotiations between the EU and the US in the reporting period about an Agreement concerning derivatives; see US CFTC, press releases of 11 July 2013, PR6640-13, and 12 February 2014, PR6857-14.

<sup>605</sup> See paras. 1546, 1644, 1652, 1655, 1702, 1735 ff. in that context. Side effects of this kind, however, need not be negative – for instance, the incoherent implementation of Basel III forces the internationally active EU banks to also meet the relatively high US capital standards, which increases the resilience of these banks vis-à-vis systemic risk at large.

<sup>606</sup> Laeven, L./Ratnovski, L./Tong, H., *Bank Size and Systemic Risk*, IMF Staff Discussion Note SDN/14/04, May 2014, pp. 7 ff.

<sup>607</sup> Cf. paras. 1555, 1584 f. above.

by the market players are available (security systems, resolution fund) and if the State's discretion as to exemption from liability for individual market participants is reduced to a minimum. In the view of the Monopolies Commission, ongoing monitoring and refining of the existing resolution and restructuring mechanisms are needed to this end.

**1772.** In contrast, the regulations on the separation of banks favoured by policy-makers appear to be a symbolic policy of dubious benefit. By contrast, the refinement of statutory deposit protection as an element of the existing private security systems is capable of making an effective contribution towards reducing implicit guarantees.

**1773.** The capital rules are at the core of the regulation to make it difficult to build up risks which can lead to an implicit State guarantee. It is regrettable that Germany favoured so-called "maximum harmonisation" in the reform of the equity requirements, and hence showed opposition to individual Member States that introduced more stringent rules. The capital rules now in force are a step in the right direction, but are still, in the view of the Monopolies Commission, much too low.

**1774.** In the event of (pro-cyclical) modes of conduct aggravating a crisis, liquidity requirements have a preventive effect against the market drying out and implicit guarantees being taken up. The introduction of a liquidity coverage ratio in the EU must generally be welcomed, but its design is not without its problems in terms of competition policy. The planned net stable funding ratio currently still raises a number of questions.

**1775.** The existing capital and liquidity rules must be supplemented by special rules for leverage financing on the monetary and capital markets. Leverage finance includes transactions such as securities lending and repurchase agreements as well as derivative transactions.<sup>608</sup> In this respect, the Monopolies Commission is in favour of the consistent implementation of the recommendation which the Liikanen Group had put forward as an alternative to its proposal on the separation of banks. This recommendation provides for a general risk restriction through non-risk-weighted capital requirements for assets held for trading. Additionally, the supervisory authorities should have the power to demand that high-risk commercial transactions be separated off in individual cases. Aside from that, a mix of risk-limiting or transparency-creating provisions and conduct on the part of the authorities would make sense in individual cases, as is recommended by the Financial Stability Board, among others.

**1776.** It is necessary to await the impact of the regulation of bonuses as an accompanying measure. The planned financial transaction tax is the object of criticism, particularly if the tax were not to be designed anti-cyclically. As an alternative to this, the introduction of a financial stability levy should be considered as has been brought into the debate by the International Monetary Fund. Punitive sanctions should address the actual problem, namely the exploitation of implicit guarantees, and not only – as at present – violations of administrative requirements.

**1777.** As a further tool to limit the expansion of systemic risks, the Monopolies Commission suggests, similar to competition law, the introduction of financial merger control for takeovers which establish or strengthen a systemically relevant position.

**1778.** In the Monopolies Commission's view, there is an urgent need to increase transparency on the financial markets in a coherent manner in order to enable both the authorities and the market participants to better evaluate risk. In contrast, allocating one-sidedly more and more individual competences to the authorities is an approach that must be viewed critically.

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<sup>608</sup> Existing regulation captures these types of business transaction only to a limited extent, which is why they are also labelled as "shadow banking activities". This is misleading in so far as they do not consist only of business conducted by shadow banks.

**1779.** It remains to be seen which development the regulation of shadow banking will take. The Monopolies Commission has a favourable view of the regulatory advances so far.

**1780.** The regulatory framework investigated in this report can contribute to reduce the distortions of competition associated with implicit guarantees. When working on the design of this regulatory framework, politicians should use the existing leeway to counterbalance one-sided preference for capital-market based company financing, to the extent that regulation distorts competition in particular to the detriment of small institutions. The international convergence should be strengthened to further the competitiveness of the European financial markets and to counteract the ongoing fragmentation of the financial markets. In that context, farther-reaching national measures should remain possible, even if they go beyond the international standard.

## ***4 The three-pillar structure of the German banking system***

### ***4.1 Overview***

**1781.** The banks active in the German banking system are commonly allocated to three groups according to their legal form. This gives rise to the so-called three-pillar structure, in which the private commercial banks form the first, the public banks the second and the cooperative banks the third pillar.<sup>609</sup>

**1782.** The Monopolies Commission is concerned that the three-pillar structure of the German banking system gives rise to distortions of competition in some areas. It should not be ignored, though, that the three-pillar structure as such contributes significantly to the stability of the German banking system, that the German banking system is powerful and in many areas marked by intense competition, and that it consequently guarantees a satisfactory supply of banking services for consumers to a significant extent.<sup>610</sup> That said, an indication of structural crustifications of the German banking system can be seen in the so-called “overbanking” which is generally recognised by all banks and authorities. In that regard, it is mostly accepted that the actual problem consists in inefficiencies and that there is no question of arguing against the existence of individual institutions or entire groups. The term “overbanking” is unfortunate in that respect.<sup>611</sup>

**1783.** The identifiable inefficiencies in the German banking system, in the Monopolies Commission’s view, result from a delineation of the banking pillars, which is not always in conformity with the market and partly artificial, as well as on rigid structures in particular within the public pillar of the German banking system. It is remarkable that the group of the public banks frequently acts aggressively in competition with the other banks, that competitive advances, and in particular advances with innovative business models, however take place within the group to a more limited extent than in the other banking groups, at least that is the tendency. An exception is the *Landesbanken* and the free savings banks, which are not controlled by a local public authority. Thus, it is probably no accident that actually these institutions were the first within the group to supply direct banking services to consumers to a larger extent (1822direkt, DKB). In addition, by taking different approaches Haspa has attempted for longer to expand in the larger metropolitan region around Hansestadt Hamburg. The Federal Cartel Office admittedly has prohibited the acquisition of KSK

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<sup>609</sup> See above Section 2.2.1, particularly, para. 1337; detailed: Council of Economic Experts, *Das deutsche Finanzsystem. Effizienz steigern – Stabilität erhöhen*, Expertise of 17 June 2008, paras. 140 ff.

<sup>610</sup> In that context, it must be emphasised that also the private and public development banks, as a part of the German banking system usually operating outside competition, had an important share in the stabilisation of the German economy in the financial and economic crisis.

<sup>611</sup> See Council of Economic Experts, *Annual Economic Report 2004/05*, paras. 378 ff.; the same, *Das deutsche Finanzsystem: Effizienz steigern - Stabilität erhöhen*, Expertise of 17 June 2008, paras. 150 ff. for a more comprehensive analysis of the efficiency problems in the German banking system.

Lauenburg by Haspa in the reporting period because the new economic entity would have gained a dominant market position.<sup>612</sup> In this context, however, there was no question of limiting the competitive activities of Haspa, but rather a question of protecting such competition in the consumers' interest against a hardening of dominance on the markets on which Haspa is active. The Monopolies Commission supports the view of the Federal Cartel Office in that decision.

**1784.** The Monopolies Commission sees the biggest risks for competition within the associated structure in that the statutes and the charters regulating the public banking system do not distinguish clearly between the common interest goals and the admissible means to reach these goals. The general interest<sup>613</sup> and competition are principally not opposed to each other.<sup>614</sup> In fact, the welfare targets to which the State rightly feels bound can frequently be achieved in competition in a particularly efficient way. Accordingly, the public banks generally have to achieve their common interest goals in competition. Shortcomings in the determination of the targets to be pursued and the admissible means, however can give rise to distortions of competition, and this not only within the public banking pillar, but in particular also in the competition between the three banking pillars. In addition, shortcomings in the determination of the admissible objectives or means can bring about violations of the market freedoms of other market participants (Articles 45, 49, 63 TFEU). Indications exist that the traditional market structures in the German banking system have already given rise to violations of the existing law or that the risk of such violations cannot at least be dismissed.<sup>615</sup>

**1785.** In the Monopolies Commission's view the general efforts to improve banking regulation present an opportunity that should be used to pro-actively target the competition distortions identified in the following sections. Political action in cooperation with the competition authorities creates the option to positively influence the competitive situation on the banking markets. That approach should promise more success than a strictly confrontational approach, as was taken in the past, for example, during the defence of the State guarantees regarding liability for default and for maintenance (*Anstaltslast* and *Gewährträgerhaftung*).

#### ***4.2 The public mandate of the public banks must be defined more clearly***

**1786.** The Monopolies Commission principally acknowledges the particular importance of the public banks in the German banking system, but it holds a more precise definition of the public mandate of these banks to be necessary. It should be clarified, in particular, how the public mandate and the economic activities of the public banks are interrelated with each other.

**1787.** The public mandate defines the business objectives of the public banks and, thus, is of central importance for them. Banks organised as public institutions (*Anstalten des öffentlichen Rechts*) principally draw from this mandate the justification for their existence. The public mandate exists for the area of competence and the territory of the relevant controlling entity.

**1788.** The public mandate is defined by statute and (derived from the statute) in the bank charters. Inside a framework established by the German Basic Law and EU law, the Legislature is free to define the public mandate. Thus, the Legislature can define public tasks which also private banks are able to fulfil in the place of the public banks – though such tasks would not constitute positive business objectives for the private banks (e.g. the furtherance of the savings idea and of competition). In

<sup>612</sup> FCO, Decision of 28 February 2012, B4-51/11 – Haspa/KSK Lauenburg.

<sup>613</sup> According to the traditional definition, services in the general interest (*Daseinsvorsorge*) include “[e]ach act by the administration to make the public, or groups of people determined on the basis of objective criteria benefit of utile services”; see Forsthoff, *Lehrbuch des Verwaltungsrechts*, Bd. 1, 10th Ed. 1973, p. 373. Narrower, however, is the definition of the Constitutional Court, see, e.g., BVerfG, Judgment of 20 March 1984, 1 BvL 28/82, BVerfGE 66, 248, 258.

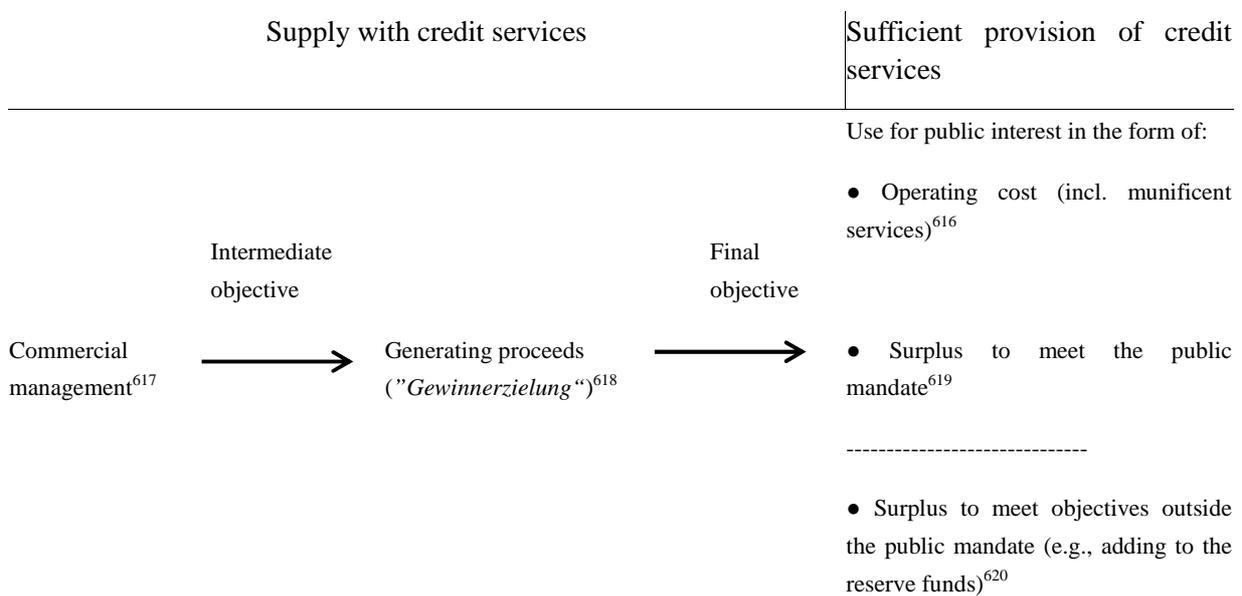
<sup>614</sup> Cf. BVerfG, Judgment of 30 June 2009, 2 BvE 2/08, Vertrag von Lissabon, BVerfGE 123, 267, paras. 392 ff.

<sup>615</sup> See Sections 4.3-4.5.

Germany, no condition exists either that the public mandate may only encompass objectives which private companies could not meet in a better fashion (subsidiarity). Conditions of that sort only exist in EU law in so far as the public mandate is used as a justification for a special treatment of the public banks in competition (Article 106(1), (2) TFEU).

**1789.** The aim of generating proceeds (*Gewinnerzielung*) is no constituting element of the public mandate. Activities for making profits do not fulfil public interests but are private-economy activities. This, however, does not mean that the public banks do not aim for public profits in the course of their business activities. They have a business management and take part in economic intercourse like private undertakings (see, e.g., § 2(3) SpkG NW) in order to generate the proceeds to meet their public interest obligations. The following diagram shows by example the typical norm structure existing in the savings bank acts for the supply with credit services, which fulfils the public mandate of sufficient provision of credit services:

**Figure VI.6: Process of supply with credit services for public interest obligations**



Source: own illustration.

**1790.** The public mandate has an effect on how the public banks pursue economic activities according to their self-image. These activities include mostly business which is at the same time intended to pursue purposes in the common interest. In contrast, the public mandate can also potentially limit the offer and provision of services which are not compatible with the public mandate.

**1791.** The public mandate is not relevant from a competition law perspective to the extent that the banks pursue it outside their economic activities. This can, for example, be the case in so far as the institutions engage in culture and sports funding activities.

<sup>616</sup> See, e.g., § 31(1) SpG BW.

<sup>617</sup> See, e.g., § 2(3)(1) SpkG NW.

<sup>618</sup> See, e.g., § 2(3)(2) SpkG NW.

<sup>619</sup> See, e.g., § 2(1), (2), § 15(1) lit. b, § 15(3) SpkG NW.

<sup>620</sup> See, e.g., § 25(1) lit. c, d SpkG NW.

**1792.** The economic activities of the public banks, however, are subject to competition law. The pursuance of common interest objectives generally does not limit the application of the competition rules, except where the activities are exempted from the competition rules under Article 106(2) TFEU.

**1793.** Politicians on the federal level and the level of the *Länder* has so far defined the public mandate of the public banks very generously (“furtherance of competition”, “furtherance of SME companies”). The Monopolies Commission, however, has pointed out that stakeholders have not been able to discern a clearly defined public mandate for the public banks for quite some time.<sup>621</sup>

**1794.** The distinction between the public mandate and the public banks’ activities to generate proceeds likewise remains unclear in many relevant statutes.<sup>622</sup> For example, the requirement of commercial management in the acts of the savings bank only very indirectly addresses the fact that the savings banks are active to generate proceeds. Likewise, in the statutes governing the *Landesbanken* and the other public member institutions of the savings bank group, the distinction between the commercial activities and the public mandate to be pursued is really quite imperfect. The situation is different only pursuant to the development bank statutes given the fact that the development banks are not allowed to pursue economic activities not linked to a public mandate.<sup>623</sup>

**1795.** The wide definition of the public mandate and the imperfect distinction between that mandate and the commercial activities give rise to unnecessary competition risks for the public banks and moreover can jeopardise the fulfilment of the public mandate. For example, it is likely that the institutions infer a special position in competition from the statutes, irrespective of the fact that this may not be justified under (higher-ranking) European competition law. The competitors and customers, in contrast, view the member institutions of the savings bank mostly like non-public banks which merely operate a purely commercially oriented business. The uneven consolidation at the level of the savings banks, the excesses of the *Landesbanken* preceding the financial crisis and the present and partly questionable expansion of the business of some development banks are moreover telling as evidence for the barely surmountable problems that the public banks face when they try to integrate the public mandate into a competitive business model.<sup>624</sup>

**1796.** From a competition policy perspective, the public mandate should be defined in a way that it is unmistakably clear which objectives the public banks are pursuing in the individual case and which restrictions follow from this purpose. In addition, it should be made clearer that the banks – to the extent that they are no development banks – are allowed to pursue also commercial interests to generate proceeds during their business activities, without such commercial interests requiring a common interest justification.<sup>625</sup> A public mandate which is more clearly defined in that way would allow the public banks to sharpen their profile in the common interest, and it would also benefit from greater legitimacy from the perspective of the competitors and consumers.

**1797.** In the following, the Monopolies Commission formulates its concerns more precisely with regard to the relevant banking groups. Additionally, it makes recommendations on how the public mandate of the public banks can be defined in a manner that is acceptable from a competition policy perspective.

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<sup>621</sup> Monopolies Commission, IXth Main Report 1990/1991, Competition policy versus industrial policy, Baden-Baden 1992, para. 52; XIIIth Main Report 1998/99, Competition Policy in Network Structures, Baden-Baden 2000, para. 125; Special Report No. 26, Regulative Guidance for a Functioning Financial S, Baden-Baden 1998, p. 91.

<sup>622</sup> Particularly unclear, e.g., § 2(1), (3) BbgSpkG, § 6(1), (4) SpG BW, § 4(1), (3) NSpG; a clearer distinction is made in contrast in §§ 2, 4 BerlSpkG.

<sup>623</sup> See below, Section 4.5.2.

<sup>624</sup> See Sections 2.2.1, 3.5.1.4 and 4.5.2 regarding the relevant aspects.

<sup>625</sup> See also BVerfG, Decision of 14 April 1987, 1 BvR 775/84, BVerfGE 75, 192, para. 22 (citation: Juris), according to which the pursuance of public interest tasks does not prevent the savings banks from also pursuing profit objectives.

### 4.2.1 *The savings banks*

**1798.** The public mandate of the savings banks under the savings bank acts has only changed insignificantly over the decades and was not affected by the financial crisis either. The traditional public mandate of the savings banks can be defined as follows:<sup>626</sup>

- Securing the provision with credit services for the entire population and small and medium-sized businesses, including in rural areas;
- The provision of credit services for the controlling public entities (as a principal bank);
- Supporting the fulfilment of the controlling entities' mandate in the areas of commerce, regional policy, and culture;
- Strengthening and securing effective competition.

The pre-cited mandate is a basis for other tasks which are derived from it in a different form by the savings bank statutes and legal doctrine, for instance, the furtherance of the savings idea and the building-up of property, the possibility of making safe deposits against interest, etc.<sup>627</sup> Generating proceeds or making profits is not part of the public mandate, but only a means to fulfil that mandate.<sup>628</sup>

**1799.** The public mandate is by law defined for the savings banks, but it is also an objective which the controlling entities, i.e., the municipalities, are meant to pursue if they engage in the credit business. Regarding the tools employed to pursue the public mandate, however, the municipalities remain free as long as they heed the task to fulfil the public mandate. Thus, the municipalities are not obliged to establish a savings bank. They can, however, do this for the purpose of engaging in private competition through the savings banks, and of pursuing the objectives defined in the public mandate.<sup>629</sup>

**1800.** This, however, leads to tensions because the public mandate of the savings banks is limited to a given territory, as is the local responsibility of the municipalities.<sup>630</sup> The savings banks must adapt to the competitive conditions if and in so far as they do not have market power and thereby benefit from a scope for conduct.<sup>631</sup> The adaptation to competition and the need to meet demand, though, has eroded the savings banks' orientation towards their public mandate. Nowadays, for example, the savings banks do not only provide credit services for the population of the municipal territory alone. They also offer services to society which are not bound to a given location or which cover the population's demand in another territory (so-called connection principle). For example, the savings banks would not decline to fund the investments of their business customers in neighbouring territories, even though they interfere thereby with the competence of the controlling entity there. In the meantime, small and medium-sized enterprises can even lease offices outside the country through their savings bank.<sup>632</sup> Thus, the savings banks have increasingly distanced themselves from the image of a credit institution oriented towards local demand.

<sup>626</sup> See, e.g., § 6 SpkG BW, Article 2 BaySpkG, § 2 BbgSpkG, § 2 SpkG MV, § 4 NspG, § 2 SpkG NW, § 2 SpkG RP. Strengthening or ensuring competition has been objective only since the 1990s; see Rümker/Winterfeld in: Schimansky/Bunte/Lwowski, Bankrechts-Handbuch, Bd. II, 4th Ed. 2011, § 124 paras. 42 ff.

<sup>627</sup> Discussion of the individual objectives, e.g., in: Beuthien, [2004] WM 1467 ff.

<sup>628</sup> Cf. § 4 p. 2 BerlSpkG, § 2(3)(2) SpkG NW, § 2(3) ThürSpkG.

<sup>629</sup> However, the municipalities are prohibited from establishing other credit institutions, see, e.g., § 107(6), (7) GemO NW, § 1(1) SpkG NW.

<sup>630</sup> Cf. § 2(1)(1) BerlSpkG, § 2(1)(1) BrdbgSpkG, § 2 SpkG MV.

<sup>631</sup> It must be assumed, though, that larger savings banks and savings banks in rural areas will frequently have market power; cf. FCO, Decision of 28 February 2012, B4-51/11 – Haspa/KSK Lauenburg.

<sup>632</sup> As is explained in an information video concerning the savings banks' S-CountryDesk; accessible:

**1801.** The savings banks were originally supposed to fulfil the public mandate of their controlling entities while observing various principles, notably the restriction of the savings bank activities to pre-defined businesses (enumeration principle), the limitation to the territory of the controlling entity (regional principle), the cooperation in the association (association principle), and the subordination of smaller local/regional institutions to larger cross-regional institutions (subsidiarity principle). In the context, elements of the public mandate were occasionally mingled with restrictions on the savings banks' economic activities.

**1802.** These principles are only reflected in a very obscure fashion in the organisation of the savings bank system today as the margin pressure created through competition has forced the savings banks to flexibly adapt their business. The savings banks have developed into commercially oriented credit institutions the business activities of which may to a significant extent be compared with the activities of other privately organised institutions (particularly the cooperative banks). In addition, the ongoing consolidation has loosened the link to the relevant controlling entities. In consequence, the above-mentioned principles (particularly, the regional principle, the association principle) today mainly serve to protect the savings banks against the competitive advances of the other savings banks and to fend off competition from the group as a whole.

**1803.** The Monopolies Commission considers it to be recommendable that the public mandate of the savings banks be again rendered more precise and at the same time be limited expressly to the use of the generated proceeds in the common interest. Under that condition, the Monopolies Commission does not consider it to be problematic if the following three objectives are defined as the public mandate of the savings banks:

- Securing the provision of credit services to the population as a whole and to small and medium-sized commerce beyond the supply that is anyway available on the market;<sup>633</sup>
- the provision of credit services to the controlling public entities (as principal banks);
- the support of the controlling entities in their tasks in the commercial, regional policy, social and cultural areas.

These objectives should in addition expressly be limited to the territory of the controlling entity, and the connection principle should be recognised expressly by law. The pursuance of these objectives could be defined more precisely (e.g., restraints on investments with the risk of losing the invested capital; the statutory obligation to offer basic accounts to everyone).<sup>634</sup>

**1804.** In any other respect, the Monopolies Commission recommends that the savings banks in principle remain free in their commercial activities under the law. This holds particularly for the manner in which the savings banks conduct their activities.<sup>635</sup> Objectives such as the savings idea and

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<http://www.countrydesk.de/homepage.html> .

<sup>633</sup> This includes the savings banks' current practice to use the generated profits to expand a particularly large cash machine infrastructure or to keep consumer credits on their books and not to sell them to speculative investors.

<sup>634</sup> See also BVerfG, Decision of 18 December 2012, 1 BvL 8/11, 1 BvL 22/11, para. 58; OVG Bremen, Decision of 23 February 2011, [2011] NVwZ-RR 503, head note 2 and para. 6 (citation: Juris), according to which the public mandate depends on the respective area of business. A statutory duty to offer accounts on a non-borrowing basis currently exists only in Bavaria, Hesse, Northrhine-Westfalia, Rhineland-Palatinate and in all Eastern German *Länder* (except for Berlin). Regarding basic accounts – not only concerning the savings banks – see also Council, Information Note of 22 April 2014, 8323/14, concerning the legislative resolution of the European Parliament of 15 April 2014 on the Proposal for a Directive on the comparability of fees related to payment accounts, payment account switching and access to payment accounts with basic features, COM(2013) 266.

<sup>635</sup> This does not exclude orders by the controlling entity. Regarding the regional principle, see Section 4.4 below.

the furtherance of competition should be abolished. In Germany, commentators rather see a risk that the consumers show excessive consumption reluctance today. The furtherance of the savings idea is moreover sufficiently warranted through the educational and informative work of the schools, and in addition through the marketing activities which the savings banks pursue in their own commercial interests. If anything, one may consider developing the public mandate of the savings banks further by including the support of sufficient private retirement provisions, based on the savings banks' original function as social welfare institutions. The furtherance of competition depends on the local market conditions (oligopoly?) and not on the existence of a savings bank alone. In that regard, it is moreover sufficient that the competition authorities monitor the compliance with the existing competition rules.

**1805.** In contrast, the Monopolies Commission welcomes the attempts of the savings banks to make their welfare-enhancing activities more transparent in their marketing and their business reports, and to thereby render more precise the public mandate of their own account. Documenting their common interest activities in the reporting could even be increased to sharpen the profile of the savings banks further and to make it possible for the public to review the fulfilment of the public mandate. Therefore, the Monopolies Commission recommends that the savings banks supplement their reporting with separately published welfare reports.

### 4.2.2 *The Landesbanken*

**1806.** The statutory public mandate of the *Landesbanken* has changed substantially over the years. At the present time, the public mandate of the *Landesbanken* can be circumscribed as follows pursuant to the applicable legal provisions and the charters of the *Landesbanken*:<sup>636</sup>

- The provision of credit services to their public controlling entities (*Landesbank*);
- Central credit institution (giro centre) for the savings banks in the relevant *Länder*;
- Commercial bank with varied commercial profiles.

Several *Landesbanken* are obliged to fulfil additional “special economic and financial policy tasks” and/or to support the pursuance of the development tasks of the *Länder* (BayernLB, Helaba, Nord/LB)<sup>637</sup>. Apart from that, the statutes set different objectives, for example the strengthening of competition, the provision of credit to the municipalities (community bank), or even – in the case of LBBW – the operation of a savings bank. Furthermore, several *Landesbanken* are responsible for operating dependent institutions or public entities, in particular special credit institutions such as building societies.

**1807.** The *Landesbanken*'s public mandate is principally limited to the territory of the controlling entity's area of competence as well. The legal bases for the *Landesbanken*, however, usually do not specifically provide for a regionally limited public mandate, although they occasionally refer to the domestic region.<sup>638</sup> Nevertheless, in particular the smaller institutions (Landesbank Bremen, SaarLB)

<sup>636</sup> Article 2 BayLBG, § 6(1) of the Interstate Agreement of 18 June 2012 concerning the Bremer Landesbank Kreditanstalt Oldenburg – Girozentrale, preamble to the Interstate Agreement of 4 February 2003 on the merger of Landesbank Schleswig-Holstein Girozentrale and Hamburgische Landesbank – Girozentrale as well as § 2 of the charter of HSH Nordbank AG in the version of 8 February 2012; § 2 LBWG, preamble in conjunction with Article 8 of the Interstate Agreement of 10 March 1992 on the creation of a joint savings bank organisation in Hesse-Thuringia, § 4 of the Interstate Agreement of 22 August 2007 on Norddeutsche Landesbank – Girozentrale, § 34 SSpG. The situation is different at the meanwhile split-up Landesbank Berlin (only central bank of savings banks).

<sup>637</sup> Article 2(2)(1) BayLBG, Article 8(4) of the Interstate Agreement of 10 March 1992 on the creation of a joint savings bank organisation in Hesse-Thuringia, § 4(1), (4), (5) of the Interstate Agreement of 22 August 2007 on Norddeutsche Landesbank – Girozentrale.

<sup>638</sup> See, however, § 5 of the Interstate Agreement of 18 June 2012 concerning the Bremer Landesbank Kreditanstalt Oldenburg – Girozentrale, which resembles the savings bank acts in that it limits the bank's

have developed a strong regional orientation. Some *Landesbanken* also pursue the mandate to contribute to the economic integration of Germany or across borders (Helaba, RP-Bank, SaarLB).<sup>639</sup> In contrast, the statutory public mandate of the *Landesbanken* in Southern Germany (BayernLB, LBBW) is only related to the territory of their controlling public entities to a limited extent.<sup>640</sup> HSH Nordbank has evolved more or less into an international commercial bank with a specialised product portfolio.<sup>641</sup>

**1808.** The *Landesbanken*'s public mandate has been exposed to stronger erosion than the mandate of the savings banks. This erosion is partly due to outside developments, in particular to the so-called Brussels Concordance, following which the legislative bodies on the federal level and in the *Länder* have abolished the previously existing liability privileges for the public *Landesbanken* and have split off the latter's development banking activities.<sup>642</sup> In part, the controlling public entities and the *Landesbanken* themselves have watered down more and more the latter's public mandate by defining the banks' tasks on the basis of alleged market demand and by ballooning the *Landesbanken* to cross-regionally or even internationally active "champions" of the public sector. In parallel, the *Landesbanken* long neglected to seek and take their place within the savings bank group.<sup>643</sup> Thus, it is a natural consequence that the withering away of their common-interest orientation fuelled the debate about the privatisation of the *Landesbanken*, and in fact led to the privatisation of HSH Nordbank, WestLB and Landesbank Berlin (and in the latter two cases eventually to their divestment). The failure of most of the *Landesbanken* (except for Helaba, Nord/LB and Bremer Landesbank) in the financial crisis, which was prevented only by use of substantial public funds put the justification of the *Landesbanken*'s existence as a whole at risk, and fed claims for the winding down or merger of the *Landesbanken* into a central institution.

**1809.** The rescue of the *Landesbanken* has led to a re-orientation process, which is not over yet. The current provisions forming the legal basis of the *Landesbanken* continue to use a broad definition of the public mandate.

**1810.** Regarding the *Landesbanken*, the Monopolies Commission likewise advocates that the public mandate be expressly linked to the use of the generated proceeds in the common interest, and in addition to specified functions for the association (central bank function). Under this condition, the following mandate may be considered for the *Landesbanken*:

- The provision of credit services to their controlling public entities (*Landesbanken*);
- Central credit institution (giro centre) for the savings banks in the relevant *Länder*;

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business territory to Bremen and Lower Saxony.

<sup>639</sup> Preamble of the Interstate Agreement of 10 March 1992 on the creation of a joint savings bank organisation in Hesse-Thuringia; § 2(1) of the Bylaws of RP-Bank; Internet portrait of SaarLB; accessible: <http://www.saarlb.de> > Über uns.

<sup>640</sup> Article 2(1)(2) BayLBG: "regionally focused on Bavaria, Germany, and the adjoining European economic areas [unofficial translation of "regional schwerpunktmäßig auf Bayern, Deutschland und die angrenzenden Wirtschaftsräume Europas konzentriert"]. § 2(3) LBWG: "The *Landesbank* is [...] an international commercial bank" [unofficial translation of "Die *Landesbank* ist [...] internationale Geschäftsbank"].

<sup>641</sup> This, however, was accompanied by a significantly increased risk; see, e.g., Deutsche Bundesbank, Finanzstabilitätsbericht 2013, pp. 51, 63-64; Bundesbank chair Dombret, as quoted in: no author, Bundesbank warnt vor Risiken durch Schiffskredite, Reuters/Handelsblatt, 3 November 2013.

<sup>642</sup> European Commission, Decision of 27 March 2002, E 10/2000 – Germany. Anstaltslast und Gewährträgerhaftung. The so-called Accord II, as part of the Brussels Concordance, allows the *Landesbanken* to pursue development bank activities in a legally separate entity under the condition that the relations between the development bank and the other *Landesbank* activities take place on a market basis (supra, Section 3.2).

<sup>643</sup> DBRS, Rating Report Sparkassen-Finanzgruppe, 10 April 2008, p. 7; accessible: <http://www.dsgv.de/de/sparkassen-finanzgruppe/rating/>.

- Supporting the fulfilment of the controlling entities' tasks in the commercial, regional policy, social and cultural areas.

These tasks should also be limited to the territory of the controlling entity, and they should also be rendered more precise.<sup>644</sup> The *Landesbanken* with controlling entities in several *Länder* and the ones operating at the German outer borders could also be entrusted with an integration mandate. The justification for the *Landesbanken*'s existence could also be reinforced by a more precise definition than today of the tasks which the institutions are meant to fulfil for the subordinate savings banks. That said, it is also true that the *Landesbanken* as well should be free in their business activities except for the imposition of their public mandate. The central bank function could be transferred to one or two institutions for efficiency reasons. Development tasks should generally not be allocated to the *Landesbanken* as there is a risk that the liability guarantees existing for the development banks may impermissibly affect the *Landesbank* business.<sup>645</sup>

**1811.** With regard to the *Landesbanken* as well, it would have to be welcomed if they use their advertising to substantiate more clearly their public mandate and to describe their common-interest activities. Such measures should be strengthened, like in the case of the savings banks.

### 4.2.3 *The development banks*

**1812.** In the case of the development banks, the business activities and the public mandate are particularly closely interlinked. The reason is that the development banks continue to benefit from State aid in the form of guarantees for liability in the case of default and a guarantee for maintenance, which have been abolished for the other public banks on the European Commission's initiative in the meantime.<sup>646</sup>

**1813.** The statutory mandate of the development banks is intended to take account of that fact.<sup>647</sup> Thus, for instance, KfW has the task of providing funding measures in particular in some individual areas defined by statute (e.g., small and medium-sized enterprises, risk capital, housing, environment and development measures), additionally to support the financing of the public institutions, to finance measures for entirely social purposes or the furtherance of education, and to provide other financing in the interest of the German and European economy.<sup>648</sup> The development banks of the *Länder* fulfil similar and sometimes more specific development tasks. According to their self-image, the development banks act mostly in cases of market failure where adequate financing is not available on the market. In addition, they act in a market-considerate manner and usually avoid direct market activity when they implement their development programmes. This implies that they use other institutions (e.g., credit institutions) as their intermediaries for the provision of financing.<sup>649</sup> Their direct market activities are generally limited to the procurement of their own financing. The task

<sup>644</sup> In the event that an institution outside the *Land* is entrusted with such tasks, legal clarity should mandate an interstate agreement instead of regulation by another *Land* in conjunction with the charter of the *Landesbank*. See, e.g., § 2(6) LBWG concerning RP-Bank and Sachsen Bank.

<sup>645</sup> Cf. Section 4.5.2 below.

<sup>646</sup> See para. 1808 above and, e.g., § 1a KfW Law.

<sup>647</sup> See Federal Government, Legislative Proposal, Gesetz zur Neustrukturierung der Förderbanken des Bundes (Förderbankenneustrukturierungsgesetz), BR-Ds. 175/03, pp. 20-21. Regarding the qualification of development banking activities under EU competition law, see moreover ECJ, Judgment of 10 January 2006, C-222/04, Cassa di Risparmio di Firenze, Slg. 2006, I-289, paras. 119 ff.; European Commission, Decision of 14 May 2009, COMP/M.5508, Soffin/Hypo Real Estate, para. 19; Communication on the application of the European Union State aid rules to compensation granted for the provision of services of general economic interest, OJ C 8 of 11 January 2012, p. 4, para. 13 (on the entrepreneurial activities of development banks) and para. 43 (on Article 106(2) TFEU); European Commission, Decision 2012/21/EU of 20 December 2011, OJ L 7 of 11 January 2012, p. 3, para. 8.

<sup>648</sup> § 2 KfW Law.

<sup>649</sup> Cf. § 3 Abs. 1 KfW Law.

profile just described is retraced in the Brussels Concordance (Accord II) which sets the State aid frame for the development bank activities. The development bank acts in Germany were adapted to Accord II.<sup>650</sup>

**1814.** This could give rise to the assumption that the activities of the development banks are always unobjectionable if the banks stay within the framework of the development acts.<sup>651</sup> This, however, is not correct as a general assumption. Rather, it is necessary to distinguish (1) whether the individual activities are pursued to meet objectives defined in the development bank acts and (2) if and to what extent the relevant activities may (also) be subject to the competition rules. The second question indicates the risks for the development banks, or the market respectively, to the extent that the (abstract) definition of the public mandate in the development bank acts takes insufficient account of competition aspects. Another, and separate, question is whether the (concrete) activity of the development banks, and thus the implementation of their public mandate, may raise competition concerns. Regarding the statutory definition of the development banks' mandate, it must be noted that there is room for an interpretation that is not necessarily in line with the provisions of Articles 106(2), 107 TFEU.

**1815.** Article 106(2)(1) TFEU indeed allows for a relatively broad definition of the development banks' public mandate for welfare policy reasons. This is because services in the general economic interest include essentially all types of services that are provided to the direct commercial benefit of society, and not only to individual members of society.<sup>652</sup> The mandate the development banks are entrusted with by law should be in line with this definition. This, however, does not mean that the activities of the development banks are exempted from European competition law. Rather, the operation of devices in the general economic interest is only exempted from the competition rules only in so far as the application of such rules does not obstruct the performance, in law or in fact, of the particular tasks assigned to the relevant bank. No farther-reaching exception can be derived from Article 14 TFEU.

**1816.** Nothing else follows from Accord II, regardless of the fact that the development banks formally remain in its framework by providing the services listed therein. Accord II makes it clear that the development banks can use the State aid advantages they benefit from in the same way and to the same extent they did at the time the Accord was agreed or how this was foreseeable at that time for the future. That notwithstanding, however, the Accord must be interpreted on the basis of the European Treaties. To the extent that European competition law is applicable under Article 106(2) TFEU, the Accord also stands under the express condition, as regards the advantages associated with the public liability guarantees, that “[i]t must be taken care [by the Federal State] that special credit institutions are only entrusted with promotional tasks in compliance with the State aid rules of the Community”.

**1817.** The application of the European competition rules would still have to be assessed more cautiously if the development banks had to be awarded some discretion regarding the question whether their action is necessary due to an existing market failure. In the understanding of individual development banks, such discretion clearly does exist. For example, according to KfW, its concrete tasks are inferred from the statutory rules by way of a dialogue between the bank and politicians. This relates not least to the question of possible market failure. KfW also decides on its own whether it can withdraw because the market situation eases again in an area where it has had development activities. Hence, the bank ascribes to itself the right to assess whether its activities are necessary to the given

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<sup>650</sup> European Commission, Decision of 27 March 2002, E 10/2000 – Germany. *Anstaltslast und Gewährträgerhaftung*, pp. 11 ff. No. 2.

<sup>651</sup> See Section 4.5.2.

<sup>652</sup> Attorney General Van Gerven, Opinion of 19 September 2001 in Case C-179/90, *Merci Convenzionali Porto di Genova v. Siderurgica Gabrielli*, [1991] E.C.R. I-5889, para. 27; regarding the development banks' business activities, see also EFTA Court, Judgment of 3 March 1999, E-4/97, *Norwegian Bankers' Association v. EFTA*, WuW/E EU-R 176 (179).

extent. Such a right to assess and review is also in line with the broad wording of the German KfW Act.

**1818.** European competition law, however, does not permit the undertakings of the State to decide on their own whether they may expose themselves to free competition.<sup>653</sup> This also applies regarding the question whether there is competition failure that justifies an economic activity outside the scope of competition law. Such competition failure is not the same as market failure. The provision of Article 106(2)(1) TFEU contains a narrow exception. It has the function to impose the burden of proof on the Member State that the performance of tasks in the general economic interest would be obstructed if the entrusted undertakings were subjected to the European competition rules. Therefore, the Member State must show that operation of the service in the general economic interest would be threatened in such case.<sup>654</sup> Thus, the development banks can only claim an exception from the European competition rules if the operation of the services they provide would be threatened if competition law were to apply. Conversely, the competition rules apply as long as it cannot be shown that the postulated market failure indeed requires an exception from the competition rules. This prevents a development where the development banks occupy lucrative business areas and there distort competition with their services, given their refinancing advantages.

**1819.** It could be considered further whether the credit supply of the development banks is a universal service that can only be performed if it is excepted to a large degree or even completely from the competition rules. In the common view, universal services are services in the general interest which an entrusted undertaking must offer all over the country at equal prices and conditions, irrespective of the profitability of the service. Such services are subject to a particularly generous assessment from a competition perspective, which specifically allows for the cross-subsidisation of loss-making services. This is due to the consideration that the financial stability of the undertaking operating in the common interest may not be undermined by competitors that are not entrusted with the service and that limit themselves to providing profitable services and compete with the entrusted undertaking only to that extent (so-called cherry-picking).<sup>655</sup> Privileging universal services, however, must be questioned as well if the establishment of a universal service is not necessary as such.<sup>656</sup> In that respect, it is necessary to assess the development bank activities in the individual case.

**1820.** In view of the broad formulation of the development bank acts, which does not take account of these restrictions, the risk exists that the development banks provide development services that are not fully in line with EU law (in particular, Articles 106(2), 107 TFEU). As concerns the compatibility with EU law, it is not relevant if the relevant service is permissible under the applicable German provisions and fulfils the mandate defined therein. To the contrary, the broad formulation of the law

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<sup>653</sup> See ECJ, Judgment of 17 July 1997, C-242/95, *GT-Link/DSB*, [1997] E.C.R. I-4453, paras. 50 ff.; ECJ, Judgment of 17 May 2001, C-340/99, *TNT Traco v. Poste Italiane*, [2001] E.C.R. I-4109, para. 56 ff.; GC, Judgment of 27 February 1997, T-106/95, *FFSA v. European Commission*, [1995] E.C.R. II-233, para. 173 (consistent case law), pursuant to which Article 106(2) TFEU must be interpreted narrowly.

<sup>654</sup> Cf. ECJ, Judgment of 23 October 1997, C-157/94, *European Commission v. Netherlands*, [1997] E.C.R. I-5699, paras. 31, 51 ff., especially para. 58. According to that, it would go too far to also require proof that not other conceivable measure would hypothetically allow one to ensure that the relevant tasks are fulfilled.

<sup>655</sup> ECJ, Judgment of 19 May 1993, C-320/91, *Corbeau*, [1993] E.C.R. I-2533, paras. 17-18; see also ECJ, Judgment of 23 October 1997, C-157/94, *European Commission v. Netherlands*, [1997] E.C.R. I-5699; Judgment of 21 September 1999, C-67/96, *Drijvende Bokken*, [1999] E.C.R. I-5751, according to which it is sufficient that the application of the competition rules would threaten the fulfilment of the particular tasks with which the relevant undertaking is entrusted.

<sup>656</sup> ECJ, Judgment of 19 May 1993, C-320/91, *Corbeau*, [1993] E.C.R. I-2533, para. 14; Judgment of 25 June 1998, C-203/96, *Chemische Afvalstoffen Dusseldorp*, [1998] E.C.R. I-4075, para. 67; European Commission, Decision of 17 December 1982, IV/29.995, *Naveva/Anseau*, OJ L 167, 15 June 1982, p. 39, paras. 65-66. Further, see European Commission, Report on services of general economic interest in the banking sector, adopted by the ECOFIN Council on 23 November 1998 (“the principle of proportionality has to be respected”).

creates the risk that the Federal State and the *Länder* violate compelling obligations under Article 106(1) TFEU and the obligation to ensure their development banks' conduct in accordance with EU law (Article 4(3) TEU).

**1821.** For these reasons, the Monopolies Commission considers it to be indispensable that the public mandate of the development banks is aligned more closely to the conditions of EU law in order to ensure that the development banks do not unduly interfere with competition through their activities. The definition of the public mandate and of the admissibility of development tasks should be aligned particularly closely with Articles 106(2), 107 TFEU in the interpretation of the European Courts. The European Commission has defined the conditions following therefrom more precisely in the meantime.<sup>657</sup> Above all, it must be ensured to a larger extent than to date that the development banks only act where no effective competition exists and where it cannot be developed so soon that no development measures are necessary. To the extent that competition exists without being able to satisfy the existing or foreseeable demand for services in the general economic interest, an approach limited to what is necessary is required, which gives preference to possible alternatives to the full development bank financing (e.g., use of the savings bank system, partial financing of products introduced by the commercial banks). Further, the transparency and reporting obligations of the development banks should be defined in a farther-reaching manner, such that other market participants and the public are able to trace back the common-interest activities of the development banks. In contrast, the Monopolies Commission takes a critical view towards marketing activities that only underline the customer orientation of the development banks, as well as all marketing activities immediately towards the consumers.

### ***4.3 The structures of and the cooperation in the associated banking groups must be monitored more closely***

**1822.** With regard to the associated banking groups (*Verbundgruppen*) in the savings bank and the cooperative bank sector, it is not possible to adopt a clear and one-sided position. The existing structures of the associated groups must generally be regarded positively in so far as they enable the group members to benefit from economies of scope and scale. At the same time, there is a risk that the opacity of the groups is being used for conduct that distorts competition. To what extent the positive or the negative aspects are more important cannot be assessed based on the information at present available, however. It must be emphasised that the transparency of the internal group structures and relations should be increased to the extent possible (e.g., through the reporting).

#### ***4.3.1 The general competition law applies in principle within the associated banking groups***

**1823.** It must be assumed that the associated banking groups form associations of undertakings, and that general competition law principally applies within the two groups (Articles 101, 102 TFEU; §§ 1 ff. ARC). In that regard, it is however necessary to take into account the characteristics of the respective group structures.

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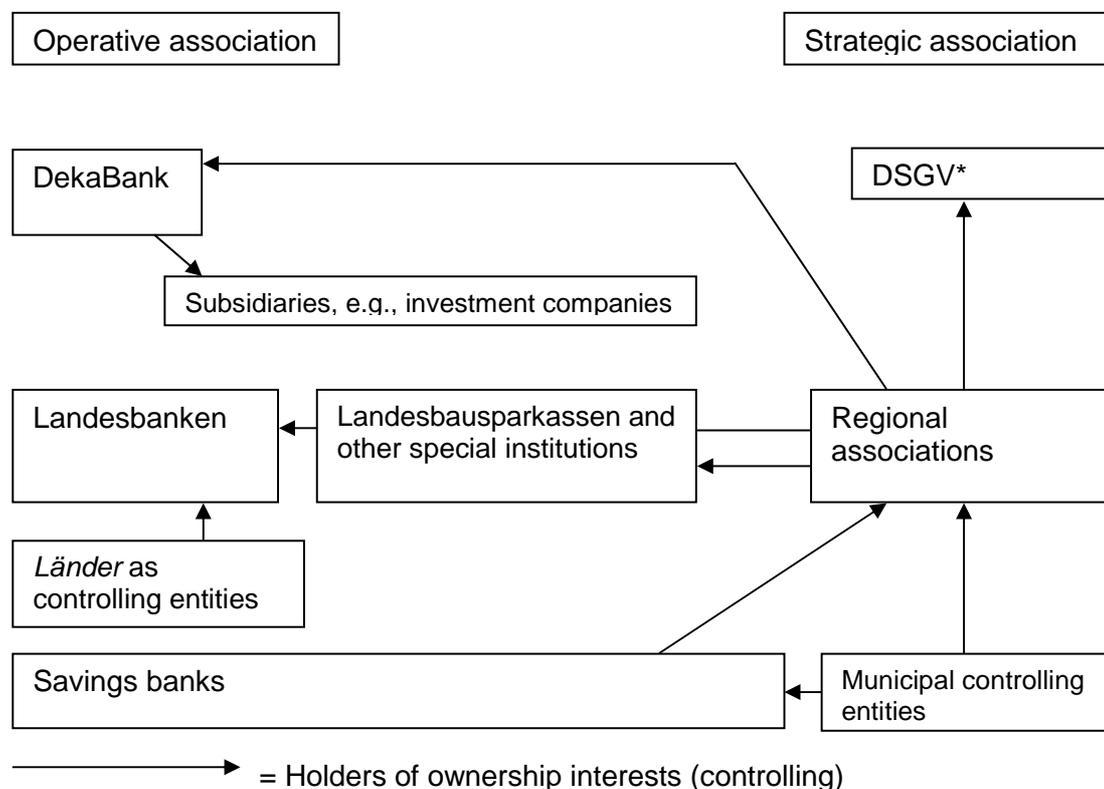
<sup>657</sup> Communication on the application of the European Union State aid rules to compensation granted for the provision of services of general economic interest, OJ C 8, 11 January 2012, p. 4, paras. 45 ff.; as to funding, see also European Commission, Decision 2012/21/EU of 20 December 2011, OJ L 7, 11 January 2012, p. 3, paras. 15 ff.

### 4.3.1.1 The savings bank group (*Sparkassen-Finanzgruppe*) within the public banking sector

**1824.** The public banking sector is formed by the savings bank group and the other banks that are controlled by the State or that pursue tasks in the common interest. A key organisational element consists in the allocation of tasks inside the associated group, the tasks frequently being imposed on the associated banks by law. For that reason, only isolated overlaps exist between the savings bank group and the other public banks (e.g., regarding the development banking activities of some *Landesbanken*).

**1825.** The *Sparkassen-Finanzgruppe* comprises an operative association and a strategic association, which both have a hierarchical structure and are closely interlinked with each other in numerous ways (here referred to as the savings bank group). This structure can be illustrated as follows, in a very simplified way:

**Figure VI.7: Savings bank group**



\* DSGV = Deutscher Sparkassen- und Giroverband

Source: own illustration.

**1826.** The operative association in the savings bank group has in principle a three-tier structure and encompasses the actual undertakings that form part of the group. The first tier is formed by the local savings banks (including the free savings banks) under the control of the local and regional territorial authorities (*Gebietskörperschaften*). The second tier is composed of the *Landesbanken* and the building societies (*Landesbausparkassen*). The nationally active and not regionally bound common lead institution is DekaBank Deutsche Girozentrale, a federal institution established under public

law.<sup>658</sup> In addition, the group includes multiple special credit institutions, public insurers, foundations, and near-bank undertakings (S-Broker, Deutsche Leasing AG, etc.).

**1827.** The organisation with allocated tasks within the operative association also means that the savings banks focus on the local and, at most, regional private and SME business whereas the *Landesbanken* have specialised for the business with corporate customers throughout a *Land* or even beyond the borders of a *Land*. In addition, the *Landesbanken* support the savings banks as giro centres in the savings bank business. DekaBank, in turn, is the central asset manager of the savings bank group. Its customer business mostly consists of investment fund products that are distributed through the savings banks and the *Landesbanken*.

**1828.** The strategic association is formed essentially by the savings bank and giro associations (*Sparkassen- und Giroverbände*), which define the association's objectives. At the first level, the savings banks and their controlling entities are members to regional associations and the *Landesbanken* are members of the association of public banks (*Verband öffentlicher Banken*). The regional savings and giro associations coordinate the cooperation in the regions through a multitude of committees and commissions, and ensure a uniform profile of the association. At the second level, the savings bank associations and the *Landesbanken* and other members of the savings bank group are organised in the Deutschen Sparkassen- und Giroverband e.V. (DSGV) as an umbrella organisation. The DSGV represents the savings bank group externally, but it is at the same time also a platform for the internal finding of positions and for the business-strategic coordination of the group. Apart from that, the DSGV also manages the institutional security system of the group, which includes the institutional security mechanisms and the security funds of the savings bank group on the regional and the federal level.

**1829.** Finally, the DSGV is supplemented by a public institution bearing the same name, whose members are the regional savings bank associations and which operates today essentially as an entity controlling the associated group's own enterprises (e.g., DekaBank).

#### **4.3.1.2 The cooperative group (*genossenschaftliche Finanzgruppe*) within the cooperative banking sector**

**1830.** The cooperative banking sector consists of two groups of institutions, i.e., the cooperative associated banking group and other cooperative banks. In particular the VR banks (Volks- und Raiffeisenbanken) are members of the cooperative group. The cooperative banks outside the cooperative group include the Sparda banks, PSD banks, the ecclesiastical banks and other special institutions such as Deutsche Apotheker- und Ärztebank.<sup>659</sup>

**1831.** The structure of the cooperative banking sector is determined by the statutory ideal of the credit cooperative as a self-regulating community with the purpose to further the gain and the cost-effectiveness of its members by way of a business operation designed to conduct business activities typical of a bank (see § 1 GenG). The statutory design of a cooperative takes account of the adaptation to a development purpose through the fact that the shares do not confer control of the cooperative. They are commonly not traded either. The credit cooperatives have been allowed to expand business to non-members in the meantime, yet this is risky. Shifting the business focus to non-members allows for an alignment with the market, but it also makes the credit cooperative to one market partner among many and thereby threatens to render the purchase of a share unattractive. In

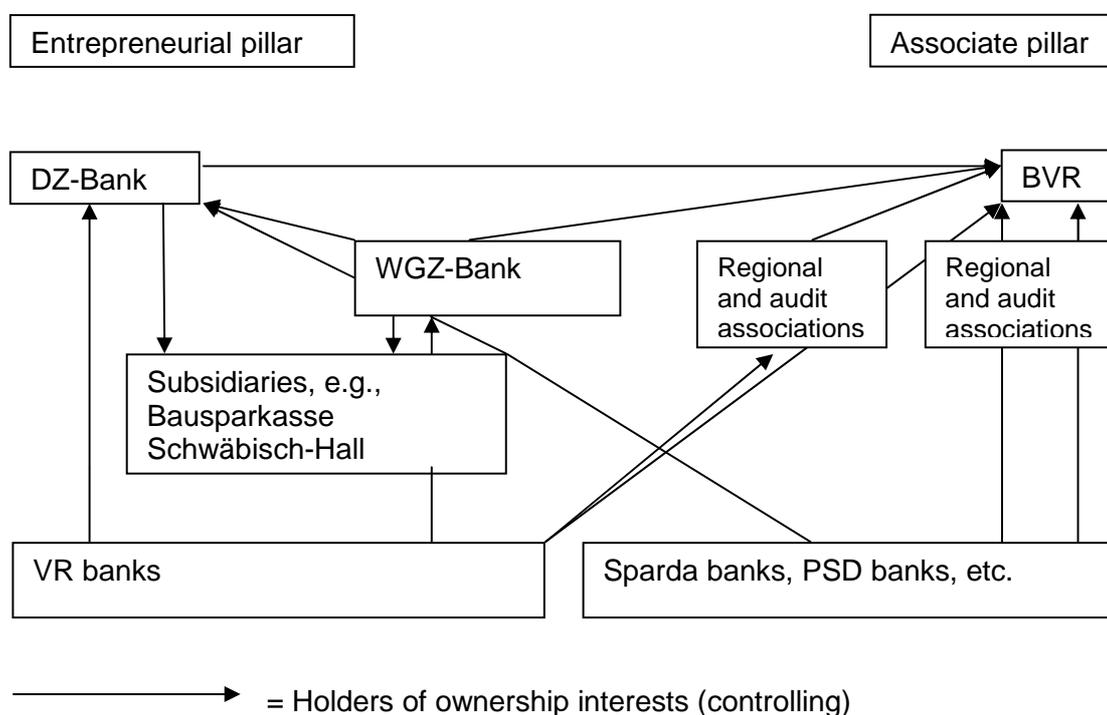
<sup>658</sup> Third Regulation of the *Reichspräsident* to secure the economy and finances and to combat political riots, 6 October 1931, Fifth Part, Chapter I, Article 2 § 1.

<sup>659</sup> See the description of the cooperative banking group on the web pages of the Cooperative Banking Association (Bundesverband der Volks- und Raiffeisenbanken): <http://www.bvr.de/p.nsf/index.html?ReadForm&main=4&sub=20>.

that way, however, the cooperative would by and by undermine its very existence. Therefore, the cooperative banks have adapted their business in a way making it relatively easy to acquire a share in a cooperative, but at the same time keeping their business at a manageable size and transferring the more complex activities to cooperatives or cooperations on a higher level. This should be an essential ground for the fact that the banking group still consists of relatively small and relatively little expansionist institutions.

**1832.** The structure of the *genossenschaftlichen Finanzgruppe* is the farthest developed in the cooperative banking sector. The group consists of undertakings and associations, similar to the savings bank group. A difference exists in that the cooperative associations coordinate the business strategy of the members to a far lesser extent, and a strategic association therefore cannot be simply presumed. The structure of the cooperative group can be illustrated in a simplified way as follows:

**Figure VI.8: Cooperative group**



Source: own illustration.

**1833.** In its entrepreneurial pillar, the cooperative group originally had a regionally layered, three-tiered structure, like the savings bank group. The first level consisted and still consists in the small local credit cooperatives (VR-Banken). On the regional level, there existed cooperative central banks at first, out of which however only Westdeutsche Genossenschaftszentralbank (WGZ Bank AG) still exists with Northrhine-Westfalia as its business area. The local credit cooperatives are the shareholders of this bank, which used to be a secondary cooperative. The lead institution of the cooperative group has been DZ Bank AG Deutsche Zentral-Genossenschaftsbank from the outset. DZ Bank is today the central bank of the VR banks (outside the business area of WGZ-Bank) and of the Sparda banks, and it is also the holding of the cooperative group (i.e., the holding of Union-Investment group, the Schwäbisch Hall building society, etc.).

**1834.** In the associate pillar, the cooperative banks are members of the cooperative regional and audit associations, which provide audit, advisory, and counselling services to the member institutions. The umbrella association of the entire associated group is the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), which includes also the other cooperative banks and the audit

associations aside from the banks and undertakings of the cooperative group. The Bundesverband, according to its self-portrayal, represents of the cooperative group, coordinates and develops the strategy of the VR banks, and advises and supports its members with regard to legal, tax, and commercial questions.

### 4.3.2 *Competitive assessment of the associated banking groups*

**1835.** The competitive qualification of the group structures of the savings bank group and the cooperative group is difficult. The structure of both associated banking groups is marked by a transitional sphere between entrepreneurial independence and corporate dependence, in which the members operate. The qualification of the group structures is determined by the role which the associations play in the support of the group members from a business strategic perspective. In addition, however, also the interlinkages between the group members have to be taken into account.

**1836.** The Monopolies Commission sees particularly in the savings bank group a gradual development to an association of undertakings that acts as an economic entity. Within the cooperative group, that development appears less pronounced so far. Both groups lay stress on the independence of the group members. This, however, cannot hide the fact that the latter also transfer strategic functions to the associations. The assessment of this development depends on the extent to which the cooperation relates to strategic business decisions, and to which it is consolidated in a structural manner.

#### 4.3.2.1 *Disappearance of economic independence?*

**1837.** The group members are only economically independent if they themselves (or their controlling entities) can independently make strategic business decisions. This requires an overall assessment of the remaining strategic decision rights. The threshold to an economic entity can, under the circumstances, also be crossed if the group members only transfer isolated strategic rights to the associations if these rights allow the associations to exert influence on the market activities of the group members and if that influence relates to strategic areas of the business activities; for example, decisions regarding the budget, the business plan, major investments and/or the appointment of senior management, taking into account that the latter is open to strategic influence only to a limited extent given the statutory requirements regarding the composition of the banks' management.<sup>660</sup>

**1838.** After the abolition of the State liability guarantees, the savings bank associations have sought to prevent a rating decline for their members (and accompanying higher refinancing costs) by endeavouring to obtain a uniform association rating (*Verbund-Rating*) and a minimum rating for the group institutions (rating floor). The rating agencies, however, require for an association rating that essential business functions have been mutualised (risk management, liquidity control, business strategy, marketing, product portfolio, liability)<sup>661</sup>.

**1839.** Therefore, the DSGV formulated binding principles on the cooperation in the group and on the future media profile in its "Berlin Declaration" on the cooperation in the group. As the umbrella organisation, it installed an association committee which "coordinates [further] the cooperation in the group through work division and mediates in the event of diverging interests". It defined the group's

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<sup>660</sup> See Consolidated Jurisdictional Notice, OJ C 95, 16 April 2008, p. 1, paras. 57, 66 ff. on the elements to which that influence must relate. Further, see, e.g.: §§ 14(1), (2); 15(1); 22(1); 24(2) SpG BW regarding the company management mandates (Management Board – *Verwaltungsrat*).

<sup>661</sup> FitchRatings, Rating Criteria for Banking Structures Backed by Mutual Support Mechanisms, 20 December 2012; accessible: [www.fitchratings.com](http://www.fitchratings.com); Moody's, Credit Opinions, *Sparkassen-Finanzgruppe*, March 2013 and February 2014; accessible: <http://www.dsgv.de/de/sparkassen-finanzgruppe/rating/>.

objectives – while stressing the business model of decentralised, individual savings banks – as striving for the establishment or maintenance of nationwide comparable framework conditions.

**1840.** In the meantime, several regional sections of the associated group have developed regional associated group concepts in the spirit of the “Berlin Declaration”, which however diverge from one another sometimes considerably. A particularly far-reaching group cooperation has been established in the Sparkassen- und Giroverband Hessen-Thüringen. The essential content of the cooperation can be sketched out as follows from a competition perspective:

- Business plan: definition of joint strategic group targets (cross-selling quota, group rating, etc.), target of a “homogeneous market appearance”, stabilisation and improvement of the group’s market position in the retail and corporate banking business;
- Financial planning: determination of cost-income targets, of a joint group reporting (joint income statement), and of a joint risk management;
- Investments: combination of the savings banks’ retail business with the *Landesbank*’s wholesale business;
- Market-specific rights: development of focus themes (e.g., S-CountryDesk).

The associated group concept is based on a group charter that defines the procedures and the decision-making process in the cooperation in a binding fashion. Parts of this associated group concept have been taken over by the cooperative banks.<sup>662</sup>

The members of the group in Hesse-Thuringia work together visibly in particular in the retail business where they use a joint website as their platform (for general marketing, but also, for instance, for real property sales). The individual savings banks’ portfolio is similar as concerns simple banking products (e.g., current accounts), though it is by no means identical. For instance, prices resemble more the prices of the local cooperative competitors and less those of other savings banks. Vis-à-vis corporate customers, each savings bank continues to have its own marketing, yet they use identical web pages. In the customers’ view, according to their business reports, the savings banks are meanwhile perceived as an “economic entity”.<sup>663</sup>

The savings bank organisation in Baden-Württemberg and HSH Nordbank together with the savings banks in Schleswig-Holstein have developed associated group concepts that are more oriented towards the *Landesbanken*. The *Landesbanken* themselves have all established so-called boards of advisers or of special advisers of which the association representatives are members and which coordinate the cooperation between the *Landesbanken* and the savings banks.

Adding to this standardisation of business policy, the savings and cooperative bank associations have finally intensified the remaining cooperation within the group in order to make the associated groups more efficient.<sup>664</sup>

**1841.** The cooperation in the associated groups, as described above, should principally suffice in substance to subject the member savings and cooperative banks to a single management.

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<sup>662</sup> Böhmer, [2006] ZfgK No. 9, 448 (449). The cooperative banking group obtained likewise an associated group rating, cf. FitchRatings, press release of 24 July 2012.

<sup>663</sup> See, e.g., Sparkasse Grünberg, Annual Report 2011, p. 13; Nassauische Sparkasse, Annual Report 2011, p. 8; Sparkasse Dillenburg, Annual Report 2011, p. 9; Sparkasse Gießen, Annual Report 2011, p. 7.

<sup>664</sup> Concerning topical elements of cooperation, see Sections 4.3.3.1-4.3.3.4 below.

### 4.3.2.2 Consolidation in a structural manner?

**1842.** That being said, it is questionable whether the cooperation is sufficiently consolidated structurally to indeed create a single economic entity. Such a consolidation only suggests itself in the savings bank group, if at all.

**1843.** In that context, it must be noted that the group is marked by multiple interconnections. For example, undertakings of the associated group can be held by one or several associations, sometimes holding them together with other bodies established under public law (e.g., *Länder*) and/or with a *Landesbank* and/or other undertakings of the savings bank group. In a typical regional associated group structure, a savings bank association would hold the shares of a *Landesbank* together with one or more *Länder* and potentially other associations, and at the same time control (by majority) a *Landes* building society as well as an insurance provider, and also have shareholdings in undertakings offering near-bank services (e.g., leasing societies) or supplying support functions (e.g., IT service providers).

**1844.** These shareholdings often appear to remain below a controlling or even competitively significant influence and are comprehensible under competition law only to a limited extent.

**1845.** Nevertheless, peculiarities must be noted that mark the relations inside the savings bank group under public law, which make it conceivable that here even relatively small shareholdings (e.g., below 10%) may be sufficient to convey a competitively significant influence. According to the jurisprudence, that type of influence requires the possibility to exert influence on the basis of a corporate-law relationship or a similar relationship, but it does not necessarily require a particular size of the shareholder's ownership interest. Rather, the influence is competitively significant already if the network of inter-company relations makes it likely that competition is limited to such an extent between the individual undertakings that the undertakings do not appear independently on the market anymore.<sup>665</sup> It is crucial whether the combination is the basis of a mutual balance of interests, which can be based on the shareholder undertaking exerting influence on the resources and the market behaviour of the undertaking in which it holds an ownership interest, or on the fact that latter undertaking aligns its competitive behaviour with the interests of the shareholder undertaking.<sup>666</sup>

**1846.** In the Monopolies Commission's view, such a balance of interests can under the circumstances also be brought about by a minority shareholding that is established by law. The establishment of that minority shareholding shows that the *Länder* legislatures expect the majority shareholders to take into consideration the interests of the other parties at the management of the relevant undertakings. Such a situation exists in the case of several *Landesbanken* in which the *Land* or individual savings banks were awarded a minority shareholding.<sup>667</sup> That minority shareholding is even more significant where the *Land* also has a large capital interests of its own.<sup>668</sup>

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<sup>665</sup> OLG Düsseldorf, Decision of 24 November 2004, VI-2 Kart 10/04(V), KG Wochenkurier, WuW/E DE-R 1390 (1394), with reference to BT-Ds., 11/4610, p. 20.

<sup>666</sup> See BGH, Decision of 21 December 2004, KVR 26/03, trans-o-flex, WuW/E DE-R 1419 (1420); OLG Düsseldorf, Decision of 6 July 2005, VI-Kart 26/04(V), Bonner Zeitungsdruckerei, WuW/E DE-R 1581 (1582); FCO, Decision of 27 February 2008, B5-198/07 – A-TEC/Norddeutsche Affinerie, WuW/E DE-V 1553, paras. 27, 44.

<sup>667</sup> See § 4(1), (7), § 5 LBWG in conjunction with § 2(1), § 3 of the Charter; Article 5(1) Helaba Interstate Agreement in conjunction with §§ 3, 4(1) of the Charter; § 3(1), § 4 Bremer LB Interstate Agreement in conjunction with § 4 of the Charter; § 3(1) Nord/LB Interstate Agreement in conjunction with §§ 2, 3 (1) of the Charter; § 32(1) SSpG in conjunction with §§ 2, 4(1) of the Charter. See also § 4 SpkG NW (regarding the Helaba-Verbundbank in Northrhine-Westfalia). Anyway, these provisions should not be a basis for assuming (parallel) interests of the majority and minority interest holders in a way that allows to add together the interests; cf. para. 76 of the Consolidated Jurisdictional Notice.

<sup>668</sup> Cf., e.g., Drost, Bremer Landesbank gibt NordLB Kontra, Handelsblatt, 29 June 2005.

**1847.** The assessment of the associated group structures, however moreover requires a comprehensive assessment which must go beyond the qualification of each individual ownership interest.

**1848.** Hence, it must be taken into account in particular that the savings banks and their controlling entities are members in the Sparkassen- and Giroverbände by law. The associations, however, do not only coordinate the decision-making process and the market stance of the savings banks vis-à-vis each other, but also in relation to the associated group institutions at the level of the *Länder* and on the federal level, in which they hold an ownership interest (e.g., *Landesbanken*, *Landes* building societies, *DekaBank*). The association system gives rise to multiple personal and business strategic relations in that regard.<sup>669</sup> In addition, the associations have made the member institutions in the past few years standardise company functions (back office<sup>670</sup> or support business) on platforms in so-called model organisations, which concern the personnel and non-personnel cost management, or to move them to other entities within the associated group altogether, for example to credit pools, data centres/IT service providers, entities for risk management, etc.<sup>671</sup> These model organisations and entities should usually not go beyond a (non full-function) collectivisation without proper market activity. In view of the associated group members' dependence on the bank office services, however, the associations obtain an increasingly significant power in that way to ensure an aligned market stance of the associations' members. This power is increased by the associations' control of the institutional security establishments of the savings bank group.

**1849.** Apart from that, however, it must also be taken into account that close forms of associated cooperation like the one of Sparkassen- und Giroverband Hessen-Thüringen have already sparked concerns at BaFin according to older press releases given the associated structural consolidation.<sup>672</sup> BaFin only approved this associated cooperation under the condition that binding decisions on the association's level would first only be made in the area of risk management, and that the single responsibility for business management would otherwise remain with the banks' management. In the associate group committee of Hesse-Thuringia, the municipal controlling entities were therefore granted a veto right. In addition, BaFin must continuously be informed of all major projects of the associated group to be able to examine them. It must be assumed that comparable supervisory requirements also exist in the other instances of group cooperation. A farther-reaching integration, in particular of the operations cooperation, apparently has not taken place so far, including in Hesse-Thuringia.

**1850.** In the Monopolies Commission's view, the cooperation steered by the associations does not remove the economic independence of the affected institutions as long as it is ensured that back-office services as well as access to the security funds is open to all association members without preconditions, and as long as the associated group committees and the other association committees limit their steering function to recommendations without making binding orders. This does not exclude, naturally, that the group members follow the associated group principles established by the association in their own interest (e.g., to obtain an associated group rating). That said, it cannot be ruled out at the present time that the individual associated group members have to obey the association objectives at least as a matter of fact, if their own business targets collide with the targets set by the association. Such restrictions on their independence should be immaterial from a prudential perspective as long as the relevant group institutions can still keep away from cooperation that threatens their solvency and liquidity. Nevertheless, this could include not only a conduct-related, but

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<sup>669</sup> These are provided for or protected by law partially only, see, e.g., Article 36 Helaba Interstate Agreement, §§ 4, 12(1), 13(1) lit. b, 19(4)(2) SpkG NW.

<sup>670</sup> Particularly resolution functions.

<sup>671</sup> See Section 4.3.3.3 below.

<sup>672</sup> Köhler, Aufsicht billigt Verbundkonzept der Sparkassen nur unter Auflagen, Handelsblatt, 4 November 2003.

even a structural restraint on competition, due to which the relevant associations and their member institutions now do form an economic entity. The Monopolies Commission sees a need to clarify this.

### 4.3.3 *Competitive assessment of the other relations in the associated group*

**1851.** General competition law applies in principle inside the associated groups of the savings and cooperative banks, to the extent that the structural connections between the group members leave room for coordinated behaviour.<sup>673</sup> In that context, however, it is necessary to also take into account the particularities of associated group cooperation. In addition, inside the savings bank group, restrictions may follow from the public controlling entities' mandate to perform tasks in the general interest. The Monopolies Commission consequently advocates a differentiated approach when analysing the competitive situation.

**1852.** That being said, it is a major obstacle to the assessment of the cooperation inside the associated groups that the groups only provide relatively little information on the business relations inside the groups. The associated groups influence the market structure in a way that the group members are never able to fully withdraw from the cooperation, and in addition, in particular competitors cooperate uncommonly closely inside the groups.<sup>674</sup> In principle, this raises the risk of competition law infringements. At the same time, the existing opacity gives leeway to the associated groups to confront the authorities with existing or alleged particularities of associated group cooperation whenever the authorities examine their practices.

**1853.** Against this backdrop, the Monopolies Commission reiterates its determination that an increase of the transparency of intra-group relationships would be very welcome from a competition-policy perspective.<sup>675</sup> It bases the following assessment to the largest extent on information that it has derived from public sources.<sup>676</sup>

#### 4.3.3.1 *Particularities of the cooperation inside the associated groups of the savings and cooperative banks*

**1854.** The two associated groups exhibit the following particularities which may explain the members' coordinated market behaviour to a certain extent.

**1855.** It is such a particularity that the members share a stable, parallel interest in the division of work and – market-related – in a cooperation for supply and distribution (vertical relationship). This interest is based on business models adapted to one another, which must be aligned with the public interest mandate in the case of the *Landesbanken* and the savings banks, and to the development of cooperative business principles in the case of the cooperative banks. As far as can be said, also increased competition does not seriously put this aligned interest seriously into question. It is true that the regional principle has eroded for the *Landesbanken* and the savings banks (see below)<sup>677</sup>, and that the *Landesbanken* and the free savings banks have made independent competitive moves. In the case

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<sup>673</sup> ECJ, Judgment of 17 November 1987, 142 and 156/87, *BAT and Reynolds v. European Commission* (“Philipp Morris”), [1987] E.C.R. 4487; BGH, Judgment of 1 October 1985, BGHZ 96, 69 = WuW/E BGH 2169, *Mischwerke*; see also Monopolies Commission, *Ist Main Report 1973/1975, More Competition is Possible*, Baden-Baden 1976, para. 887.

<sup>674</sup> For the details, see Section 4.3.3.1-4.3.3.5 below.

<sup>675</sup> See para. 1822 above.

<sup>676</sup> The Monopolies Commission regrets that the BVR responded rather generally to its questions related to the associated group, despite repeated possibilities to reply, and that the DSGV, on its request, abstained completely from a reply; BVR, Reply of 18 December 2013, answers to questions II.1-5; DSGV, reply by telephone on 5 May 2014 as to the Further Questions of the Monopolies Commission of 23 October 2013 to the DSGV.

<sup>677</sup> See Section 4.4.

of the VR banks as well, the regional principle does not exclude competition within the capacity of the individual banks from the outset. That being said, the associated group structure as such remains stable and efficient in the case of both banking groups.

**1856.** Another particularity is it that the uniform market appearance of the associated groups is ensured essentially through the aforementioned connections through the group associations. These connections allow the level of the primary institutions (savings banks or VR banks) to form a common position regarding the coordination of the group in the market, and to enforce it throughout the group.

**1857.** Accordingly, the influence of the lower level (savings banks/cooperative banks) on the higher levels (central and special institutions; e.g., DekaBank/DZ-Bank; to a limited extent: the *Landesbanken*) marks the associated groups also in the operative business. It cannot be ruled out that influence is also exerted the other way in the individual case, but this is generally not intended. Thus, the vertically layered cooperation in the associated group does not have the purpose at all of coordinating the group's business policy from the level of a superior central body. Rather, the purpose is to concentrate the development and supply of products there, which would overburden the capacities of the lower levels and would make the lower institutions get in the way of each other. Then again, the central and special institutions can use the associated groups' savings banks and VR banks also as their distribution channels.

**1858.** The cooperation within the associated groups in principle does not raise concerns to the extent that they use the cooperation to generate efficiencies in the public or the consumer interest. In so far, it does not raise concerns either that they may on the one hand benefit from certain advantages of affiliated companies (e.g., the zero weight of intra-group claims), but that they also sustain advantages through their decentralised structure on the other hand, which would be lost if they consolidated the group structure more like in a corporate group (e.g., avoiding consolidated supervision, group accounting, and group liability).

**1859.** A conclusive assessment of the cooperation in the associated groups is here not possible, however. It cannot be excluded that the limits of what is permissible under competition law are being overstepped in certain cases, and that the cooperation in the associated groups contributes appreciably to the foreclosure of regional markets and of the German banking market as a whole.

#### ***4.3.3.2 The statutory organisation of the associated group cooperation in the public banking pillar***

**1860.** In the savings bank group, the associated group cooperation is protected specifically by a number of provisions related to competition. For example, the savings bank acts provide that

- the savings banks operate the building-saving business, the investment business and the insurance business within the associated group of the savings bank group,<sup>678</sup>
- the associated group is supposed to continuously enlarge the joint market positions through the cooperation of the group members,<sup>679</sup> and
- the cooperation with business partners outside the savings bank group may not impair the associated group principle.<sup>680</sup>

<sup>678</sup> See, e.g., § 6(2)(2) SpG BW, § 2(5)(2) SpkG RP, § 2(2) BbgSpkG in conjunction with § 4(1) BbgSpkVO, § 2(2) ThürSpkG; more open § 3(1)(2) SSpkG, § 30 ThürSpkVO.

<sup>679</sup> § 4(2) SpkG NW.

<sup>680</sup> § 4(1)(2) SpkG NW, § 3(1)(3) SSpkG, § 4(2) BbgSpkVO, § 4(2) SächsSpkVO.

**1861.** The Monopolies Commission, however, has doubts whether European competition law is sufficiently taken into account in that regard (Article 106(1) TFEU, Article 4(3) TEU).<sup>681</sup> The organisation of the cooperation in the savings bank group does not appear exempt from European competition law simply because the relevant provisions are part of the organisational power of the State. This sovereignty relates to provisions on the establishment of public undertakings that operate services in the general economic interest. In that regard, the sovereignty of the entities controlling the savings bank group is also specifically protected by EU law (Articles 345, 14 TFEU). In contrast, the economic activities of the relevant undertakings are subject to European competition law (Articles 101 ff. TFEU).<sup>682</sup>

**1862.** However, it may already be questioned whether group cooperation is covered by the organisational sovereignty of the *Länder* as the *Länder* are not controlling the relevant undertakings. In particular, they do not control the savings banks. The creation and operation of the savings banks are rather part of the unlimited competence of the municipalities (Article 28(2) of the Basic Law).

**1863.** Further, it cannot be assumed that the regulation of intra-group cooperation is excepted from competition law because the savings banks operate services in the general economic interest; in particular because they ensure the provision of credit services to the State and the private economy as a universal service. An exception from the competition rules only exists to a very limited extent in so far as the application of these rules would be an obstacle to the provision of those services (Article 106(2) TFEU). However, it cannot be assumed that the group cooperation provided for in the savings bank acts relates to services in the general economic interest in its entirety.<sup>683</sup> This cannot be assumed in particular in so far as the provisions ensure the operation of services that are the normal tasks of any bank. It must also be questioned whether the cooperation in the group – to the extent that it relates to the particular tasks of the savings bank group – is even necessary in so far as it is covered in the savings bank acts.

**1864.** To the extent that the competition rules apply, it is questionable whether the statutory cooperation in the group is organised within the bounds of Article 101 TFEU. This cooperation includes very varied forms of cooperation. These may partially be neutral as regards competition (working group principles) or be justified by inherent efficiencies, but they have partially also the potential to restrict competition without justification. The Monopolies Commission recommends re-assessing the relevant statutory provisions, taking into account the following evaluation of the cooperation of the two associated groups.

#### 4.3.3.3 *The role of the associations*

**1865.** From a competition perspective, the role of the associations as a platform to coordinate the economic activities of the group members and to determine their intentions must be stressed in particular. This role is relevant in different ways if one assesses the tasks which the associations fulfil in the respective associated banking group. In that respect, the following tasks must be distinguished:

- Securing a common market appearance (use of brands, marketing web presence);
- Development of joint concepts and business strategies;
- Organisation of intra-group comparisons and enabling possibilities for an exchange of experiences;

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<sup>681</sup> Cf. ECJ, Judgment of 21 September 1998, 267/86, Van Eycke, [1988] E.C.R. 4769; Judgment of 1 October 1998, C-38/97, Librandi, [1998] E.C.R. I-5955, paras. 26-27.

<sup>682</sup> See para. 1792 above.

<sup>683</sup> Cf. European Commission, XXVIIIth Report on Competition Policy 1998, para. 269.

- Collection of information in auditing bodies and associations;
- Counselling association members and training;
- Division of work in the associated banking groups, which in the savings bank group includes, among others, the participation in the *Landesbanken*' (consulting) committees of savings banks, cross-selling;
- Measures to protect the structure of the associated group (e.g., the acquisition of ownership interests, the exclusion of privatised members from the institutional security mechanism).

**1866.** In that respect, the associations coordinate the commercial activities of the association members by making coordination possible for the association members by means of the associations' resolutions and their support. Such coordination is relevant under Article 101 TFEU, §§ 1, 2 ARC in case the members of the associated group exhibit market conduct diverging from the normal conduct of undertakings acting independently in competition.<sup>684</sup> That said, an individual-case assessment is necessary as to whether such coordination has the object or effect of restricting competition, and whether such restraints on competition must be tolerated in view of the prevailing consumer benefits associated with it.

### *Securing a common market appearance*

**1867.** The measures taken to ensure a common market appearance include ensuring that the associated group members show a uniform profile in the market. Additionally, however, it can span entrepreneurial initiatives, for example the planning of products and platforms for the group members' banking services.

**1868.** For the savings banks, securing a common market appearance is a result of the perception laid down in the "Berlin Declaration" that "no undertaking of the group would be in a better position to meet the challenges of global competition alone".<sup>685</sup> Similarly, the measures to secure the market profile of the cooperative banking group are based on the awareness that the business model of the VR banks requires common strategies and concepts within the cooperative banking group in order to thereby "combine decentralised entrepreneurship and bundled product and service competence".<sup>686</sup>

**1869.** Forms of cooperation enabling the participants to actually become active on the market in the first place regularly do not restrict competition (so-called working or project groups). Thus, for example, measures enabling small savings or cooperative banks to offer their customers efficient direct banking may, under the circumstances, fall into this category. In any case, the justification of potential competition restraints is out of question in this case. Such justification should also be possible where the associations plan additional products which the associated group members can distribute alongside their own products.<sup>687</sup>

**1870.** In contrast, it is more of concern if the cooperation only is for joint marketing and if it takes place even though the participating group members could act independently on the market. In such case, it cannot be ruled out that the cooperation is used to coordinate prices, for collusion on strategic

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<sup>684</sup> ECJ, Judgment of 14 July 1972, 48/69, ICI, [1972] E.C.R. 619, para. 64/67; Judgment of 14 July 1981, 172/80, Züchner, [1981] E.C.R. 2021, para. 14; equally ECJ, Judgment of 4 June 2009, C-8/08, T-Mobile Netherlands, [2009] E.C.R. I-4529, para. 41 following Attorney General Kokott, Opinion of 19 February 2009, paras. 66-67.

<sup>685</sup> Berlin Declaration, p. 3 No. II.1.

<sup>686</sup> BVR, Annual Report 2005, p. 2; Annual Report 2006, pp. 16 ff. (illustrating the responsibilities of the relevant association committees).

<sup>687</sup> Cf. FCO, Activity Report 2007/08, BT-Ds. 16/13500, pp. 38, 139 (OSV consumer credit card).

information, or to pursue market or customer sharing arrangements. Likewise, cooperation must be appraised more critically if there is a risk of market foreclosure.

**1871.** Accordingly, the applicable guidelines mandate an individual assessment if the participating undertakings jointly have a market share of more than 15%.<sup>688</sup> The savings banks themselves regularly point to their high market shares in retail banking and the SME credit business. The cooperative banks can likewise have relatively high market shares on regional markets, either alone or jointly with the savings banks (particularly in rural areas).

**1872.** The savings banks' joint advertising campaigns nowadays mostly do not give rise to concern after the Federal Cartel Office had admonished them for promoting so-called light-house products in 2006 and after the advertising strategy had been adapted.<sup>689</sup> The criticised advertisements were based on agreed-upon prices and conditions, and had the potential to hinder the individual development of novel products. This was not counterbalanced by sufficient consumer benefits (e.g., uniform information). The savings banks, however, desisted from mentioning prices at joint advertisement campaigns in the following advertisements. Moreover, the advertisements have become more generally phrased in the meantime, allowing the members of the associated group to individually fashion their products individually and in their own entrepreneurial responsibility.<sup>690</sup>

**1873.** Likewise, the measures the association adopted to unify the branding and to further the recognition of the “*Sparkasse*” label and the other trade marks of the savings bank group (*Sparkasse* “S” logo, colour trade mark “red” [HKS 13]), as a rule, do not imply coordination unjustifiably restricting competition. That being said, concerns regarding a potential abuse of dominance or the capital market freedom cannot be ruled out from the outset.<sup>691</sup>

**1874.** At the VR banks, joint advertisement is directed more to general information and promoting the idea of cooperatives. In that regard, there is likewise no immediate reason for concern.

### ***Development of joint concept and business strategies***

**1875.** In so far as the associations develop joint concepts and business strategies to ensure a common market appearance of the associated group to the extent spelled out above, this does not give rise to immediate concern. The same should hold with regard to the recommendations issued by the regional savings and giro associations for the appraisal of credit securities, which are binding for the savings banks in parts.<sup>692</sup> These recommendations provide for a uniform and adequate credit assessment, raising efficiency, and they are also made public.

**1876.** In the same vein, it typically does not raise concerns if the associations develop concepts for process rationalisation within the associated group. For example, rather comprehensive concepts already exist in the savings bank group, which facilitate and harmonise company processes and which are integrated in so-called model organisations (*Modellorganisationen*), for instance:

- Standardisation of credit processing (Model K);
- Harmonisation of certain product and customer service processes (Model M);
- Company analysis and rationalisation of the company organisation (Model O);
- Optimisation of process engineering/risk control in the passive/service business (Model P);

<sup>688</sup> European Commission, Guidelines on horizontal co-operation, OJ C 11, 22 January 2011, p. 1, para. 241.

<sup>689</sup> FCO, Activity Report 2005/2006, BT-Ds. 16/5710, p. 158.

<sup>690</sup> Cf. FCO, Activity Report 2007/08, BT-Ds. 16/13500, pp. 38, 139 (“bestzins” cooperation).

<sup>691</sup> See para. 1898 below and Section 4.6.1.

<sup>692</sup> § 6 BbgSpkVO; § 6 MVSpkVO, § 6 p. 2 SpkVO NW, § 6 SächsSpkVO, § 6 SAnhSpkVO.

- Optimisation of near-to-default credit management (Model Pro);
- Rationalisation of staff activities (Model S);
- Capacity management from acquiring to service completion (*Produktabschluss*) (Model V);
- Supplemental IT system platforms (OS Plus, OSP Kredit, etc.) and tools (e.g., GS-Optimizer); Sparkassen intranet (S-InfoNet).

At the cooperative banks, similar models are developed by or in cooperation with the German cooperative bank academy (Akademie Deutscher Genossenschaftsbanken). This optimisation of process structures allows the group members to adapt the available concepts individually for their use in the specific circumstances. Thus, they should keep enough leeway to manage their business independently.

**1877.** The development of business strategies must be assessed in a more differentiated way, in contrast. Such forms of support are likewise unobjectionable, in principle, to the extent that they relate to the legally permissible objectives of the associated group. The same holds for support raising the efficiency of individual institutions, if these benefits are passed on to the consumers. In contrast, support measures only improving the earnings situation or the market situation give rise to competition-law concerns as each group member must generally keep its independence in that regard. In particular in narrow associated group structures, for example in Hesse-Thuringia, there is a risk that cooperation in the group limits the members' independence excessively. In that regard, the assessment must be the more critical the more there are also appreciable barriers to market entry, as is probably regularly the case in the frequently rather rural markets where the group member institutions are active.<sup>693</sup>

**1878.** The Monopolies Commission has some concerns that the development of joint concepts and business strategies could exceed what is permissible under the law. The external survey prepared by Prof. Koetter, which had been commissioned by the Monopolies Commission and the Economic Experts Council, has produced empirical evidence showing that the savings banks and the cooperative banks were able to generate substantial (price-cost) margins particularly in rural areas in the past. The potential for achieving higher profits was higher in Eastern than in Western Germany. This might indicate that the associated groups, the lack of appreciable competition, were not forced to organise their service portfolio in the most efficient way, while they were at the same time subject to an increased default risk. Beside that, however, the savings and cooperative banks have been able – particularly after the outbreak of the financial crisis to benefit from the close group structures in the associated groups. The survey results do not allow one to draw definite conclusions as to the causes for the profitability of the associated group institutions in rural areas.

**1879.** In the following, the Monopolies Commission has conducted its own empirical regional survey to investigate the current account conditions of the two associated groups throughout Germany.<sup>694</sup> In this context, also a comparison of the account conditions within the savings bank group was conducted across the regional association borders. However, the results do not allow for definite conclusions. Hence, there is further need for clarification.

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<sup>693</sup> See Koetter, M., Market Structure and Competition in German Banking, supra (fn. 10); moreover, see Sections 4.3.3.4 and 4.3.3.5 below and Section 5.4.2 (*cash machines*).

<sup>694</sup> See Appendix C.

### *Organisation of intra-group comparisons and enabling possibilities for an exchange of experiences*

**1880.** For both associated groups, the associations are a natural platform for the organisation of intra-group comparisons (benchmarking).<sup>695</sup> Furthermore, the associations form a large number of committees, working groups and circles. These allow the group members and their controlling entities to exchange experience, an exchange partly related to commercial issues, but which can also span the cooperation or individual initiatives in social or cultural areas.

**1881.** These varying forms of exchange between the group members and their controlling entities are relevant from a competition policy perspective only in so far as they give rise to an exchange of strategic business information. Information can be regarded to be strategic if it makes it possible to make inferences as to the future market conduct of individual group members.<sup>696</sup> The data collections which the associations make available to their members for intra-group comparisons can be assumed to provide a basis for the comparison of elements such as financials, customers, processes, and personnel, frequently going far beyond the data which an institution typically has at its disposal individually.<sup>697</sup> The exchange of experiences in the association committees allows the group members to broaden and complement this information.

**1882.** Such information does not have to raise serious concerns if it serves legitimate objectives of group cooperation. The precondition is that the exchanged information is necessary and used to generate efficiency effects in the interest of consumers, and that it does not foreclose competition (Article 101(3) TFEU, § 2 ARC). In addition, however, appropriate measures are necessary that strategic information is only used for such admissible purposes (e.g., by way of ring fencing). In view of the high combined market shares that the associated groups must be assumed to have on many local and regional markets in retail and SME banking, and given the high supply-side transparency on these markets, there is an argument for strict requirements regarding the exchange of business information within the associations.

**1883.** From the outside, it is not possible to assess if the exchange within the associations exceeds what is admissible under competition law. Only limited information is publicly available regarding the organisation within the groups.<sup>698</sup> That said, the personal links within the associations give rise to concerns. According to the charters of the savings bank associations, for example, the savings banks' directors are organised in working groups and circles.<sup>699</sup> Such working groups frequently deal with questions where a competitive justification of the cooperation stands to reason (e.g. controlling, process and risk management). In other cases, however, the exchange can relate to strategic questions of business policy (e.g., concerning products, markets, distribution).<sup>700</sup> As stated above, this is particularly likely in the savings bank associations that have established an increased group

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<sup>695</sup> See European Commission, Communication of 16 April 1997, Benchmarking – Implementation of an instrument available to economic actors and public authorities, COM(97) 153 final, and Opinion of the Committee of Regions, OJ C 64, 27 February 1998, p. 1, Section 4.1.

<sup>696</sup> Cf. European Commission, Guidelines on horizontal cooperation, *supra*, para. 86; OLG Düsseldorf, Decision of 27 July 2002, Kart 37/01 (V), Transportbeton Sachsen, WuW/E DE-R 949, Section A.2.a; FCO, Sector Inquiry Milk, January 2012 – Final Report, paras. 139 ff., and September 2009 – Intermediate Report, pp. 114-115.

<sup>697</sup> Cf. BVR, Annual Report 2006, p. 22, on the topics for intergroup comparisons.

<sup>698</sup> Charters, in particular, have been published only partially and are missing, e.g., in relation to the DSGVO and several regional savings bank associations.

<sup>699</sup> Cf., e.g., §§ 17-18 of the Charter of the OSV, § 15 of the Charter of the RSGV, § 16 of the Charter of the SVWL.

<sup>700</sup> This is indicated by the publications on trainings; see, e.g., ADG, Managementprogramme Banken, Annual Programme 2014, pp. 12/13 ff.; Privatkundengeschäft, Annual Programme 2014, p. 8/9 (particularly as to pricing policy); Sparkassenakademie Bayern, Programme 6741 – GSW-Infotag, 9-31 December 2013.

cooperation.<sup>701</sup> In these cases, it may be warranted for the competition authorities to verify the admissibility of the exchange.

### *Collection of information in auditing bodies and associations*

**1884.** The activities of the auditing bodies of the regional savings bank associations and the auditing associations in the cooperative group are based on statutes (e.g., § 26 Abs. 2 BbgSpkG, § 53 GenG) and unobjectionable as such as they primarily raise the security of the group members' business. That said, the auditing activity is also a basis for the collection of information that is partially used for intra-group comparisons and the exchange of experiences within the association.<sup>702</sup> Competitive concerns can arise if the – frequently strategic – information collected for auditing purposes is collected centrally and re-used for other purposes.<sup>703</sup> In these cases, it must be ensured that the information is neutralised competitively before it is re-used within the association, making inferences on the market behaviour of individual association members impossible.

**1885.** Further, it is worthwhile considering whether the auditing bodies and associations responsible for the individual association members should rotate regularly across association borders.<sup>704</sup> Such a measure would loosen the connections between the regional associations and individual institutions, thereby contributing to the neutrality of the auditing bodies and associations.

### *Counselling association members and training*

**1886.** To the extent that the counselling and the training of employees are relevant from a competition perspective, the principles set out above apply correspondingly.

### *Division of work in the associated banking groups*

**1887.** The associations in both associated groups supervise the division of work in the group in order to ensure efficient market handling. In addition, the associations further the cross-selling of complementary banking products and services within the group and the distribution of such products through savings banks/VR banks to the private end-customers.

**1888.** This cooperation can be unproblematic as a form of specialisation if the group members abstain from developing products and source the products instead from other group partners for re-sale. It can equal such abstinence if the controlling entity unilaterally prohibits an institution from supplying certain products.<sup>705</sup> Equally, there is generally no room for a distortion of competition if the group members source products that they cannot develop themselves. In other cases, the specialisation within the group can be entitled to be exempted if the relevant undertakings have a market share on each relevant market of 20% or less.<sup>706</sup>

**1889.** That being said, indications exist that the division of work has not been limited to such product-related specialisation in the past. In both associated groups, the group members of the various levels have more or less avoided entering into competition for the same customers, regardless of any

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<sup>701</sup> See para. 1877 above.

<sup>702</sup> As to the savings banks, cf. LMF Brandenburg, No. 2.2 of the Circular Decree (*Runderlass*) of 27 June 1991 on the assessment of the public savings banks; LMF NW, No. 3.2 of the Circular Decree of 12 February 1996; LMI SH, No. 3.2 of 20 April 1998.

<sup>703</sup> §§ 4-8 of the Model Charter of the savings banks' security fund (*Sparkassen-Stützungsfonds*).

<sup>704</sup> Rotating is already possible in Northrhine-Westfalia, although it is not mandatory, see § 24(3) SpkG NRW.

<sup>705</sup> Cf. § 3(1)(3) of the Charter of BayernLB, which however prohibits the distribution of savings deposits directly.

<sup>706</sup> Article 3 of Regulation 1218/2010, OJ L 335, 18 December 2010, p. 43; see also European Commission, Notice of 18 December 1978 on the assessment of certain subcontracting agreements, OJ C 1, 3 January 1979, p. 2.

specialisation or sales co-promotion. This customer-related division of work is, however, increasingly eroding.

**1890.** In particular the savings bank associations had enforced a strict division of work within the group as a reaction to interference with the savings bank business (e.g., by *Landesbanken*) before the financial crisis. Thus, the committees of the DSGV agreed before the “Berlin Declaration”, according to press reports, that retail banking should be reserved to the savings banks and that certain customer groups should clearly be allocated to the *Landesbanken* or the savings banks. Where the “division of work” was violated, “solutions compatible with the associated group principles” should be found and “violations of the rules [should be] eliminated”.<sup>707</sup> For the coordination of the cooperation with work division and for mediation, an associated group committee was installed at the DSGV level. This division of work apparently continues to exist to date.<sup>708</sup> Nevertheless, the *Landesbanken* no longer seem to feel bound under all circumstances to the original work division.

**1891.** The end of the customer-related work division in the group would be welcome. Such customer segmentation cannot be regarded as specialisation, but it is a serious restriction of competition that is generally not excepted (hardcore restriction).<sup>709</sup> It is, in particular, no mere ancillary restraint within the framework of the cooperation within the associated group. This would only be the case if the segmentation of customers would be directly related to the cooperation in the associated group and necessary for it, using an objective benchmark.<sup>710</sup> Where the agreed practice is that individual group members (e.g. the *Landesbanken*) are barred from approaching the same customers as other group members (e.g., the savings banks), this is not the case, though, even if the cooperation increases group-internal efficiency. No further justification follows generally for such customer segmentation from the fact that increased intra-group efficiency creates fairer competitive conditions as regards the relationship between the associated group members and the private banks.<sup>711</sup> This assumption would be justified to a certain extent if the group members were subject to single control by one entity. This is, however, not the case. It is true that the controlling entities, in principle, share the interest to generate the proceeds by way of intra-group cooperation to fulfil their respective public mandate. That said, it is not excluded from the outset that one controlling entity may consider it acceptable that the group institutions under its control enter into some competition with other associated group institutions. In any case, organising intra-group competition is no matter for the groups, but for their controlling entities and the Legislature, taking into account Articles 101 ff. TFEU.

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<sup>707</sup> Drost, Sparkassen streben klare Arbeitsteilung an, Handelsblatt, 28 October 2005, quoting the president of the Bavarian savings bank association, Naser; see also Sparkassen-Finanzgruppe Hessen-Thüringen, press release No. 72/2005 of 7 November 2005, Sparkassen und Landesbanken einigen sich auf Arbeitsteilung; Mussler, Landesbanken mit und ohne Sparkassen, FAZ, 16 April 2009; critically Hilgert/Krahen/Merl/Siekmann, Streitschrift für eine grundlegende Neuordnung des Sparkassen- und Landesbankensektors in Deutschland, 21 November 2011; accessible: [http://www.hof.uni-frankfurt.de/images/Streitschrift\\_Vollversion.pdf](http://www.hof.uni-frankfurt.de/images/Streitschrift_Vollversion.pdf).

<sup>708</sup> However, it cannot be excluded in the cooperative FinanzGruppe either that a direct influence is exerted on the business relations of group members, cf. Böhnke, Genossenschaftsbanken: Im Spannungsfeld zwischen Tradition und Moderne – Kontinuität und Innovationsvermögen als Erfolgsstrategie für die Zukunft, Working Paper No. 125 of the Institut für Genossenschaftswesen der Westfälischen Wilhelms-Universität Münster, April 2012, p. 6 (3. Abs.); accessible: <http://hdl.handle.net/10419/74477>.

<sup>709</sup> See also Article 4 lit. c of Regulation 1218/2010, supra (fn. 706). This “work division” could also have contributed to the decision of the *Landesbanken* to engage in lending substitution in the run-up to the financial crisis; cf. para. 1439.

<sup>710</sup> European Commission Notice, Guidelines on the application of Article 81(3) of the Treaty (Guidelines on Article 81 (3) of the Treaty), OJ C 101, 27 April 2004, p. 97, paras. 29, 31; see also European Commission, Notice on restrictions directly related and necessary to concentrations, OJ C 56, 5 March 2005, p. 24, para. 40.

<sup>711</sup> Cf. European Commission, Guidelines on Article 81 (3) of the Treaty, para. 47 as to Article 101(1) TFEU and paras. 86, 90 ff. as to Article 101(3) TFEU.

**1892.** In part, concerns also arise as to the cooperation within the boards of advisers or of special advisers, in which representatives of the savings bank associations and of the *Landesbanken* come together. These advisory boards were established to facilitate advice for the *Landesbanken*, and they monitor the agreements reached with the savings banks. In addition, they are a forum for the discussion of *Landesbank* services (including prices) vis-à-vis the savings banks, additions to the product range, basic questions of cooperation, and possible new agreements.<sup>712</sup> The participation of the representatives of the savings bank associations, however, requires price-related coordination of the savings banks' demand. Such cooperation is not admissible merely because it takes place with the agreement of the *Landesbanken*.<sup>713</sup>

**1893.** In contrast, the cooperation through cross-selling within the savings bank group generally does not give rise to concerns, even to the extent that such cooperation requires restraints on competition that are directly related and necessary to it. Cross selling enables the group members to offer an aligned and comprehensive range of banking services. This generally gives rise to significant efficiencies.

**1894.** The fact that the VR banks are not able to develop the products offered by the central institutions probably explains the work division between the various layers of the cooperative group to a larger extent than in the savings bank group. For the central institutions, it is conversely advantageous from a commercial perspective to use the VR banks' retail network for the distribution of their own products. No indications exist as to the customer segmentation practised in the savings bank group.

### *Measures to protect the structure of the associated group*

**1895.** The associations defend the joint interests of the group members externally by acting as the mouthpieces of the associated groups, protecting the groups' brands against external competition, or even by acquiring ownership interests or withdrawing group benefits from individual members, to the extent that this appears necessary in the interest of sustaining the group structure.

**1896.** The associations' actions as group representatives ("mouthpiece") for the association members does not give rise to concerns if and to the extent that it is limited to articulating externally the interests of the entire group.

**1897.** The other activities must be assessed as entrepreneurial activities of the associations themselves.<sup>714</sup> In that context, the associations do not merely act as the representatives of their members. Allowing the use of a trade market is a service that covers demand, and it is hence an economic activity. Likewise, the acquisition of ownership interests and the withdrawal of commercially relevant association services constitute economic activities, irrespective of the fact that the relevant services are not offered on the market.<sup>715</sup>

**1898.** The protection of the groups' brands and trade marks is a legitimate objective of the associations' activities (see also Article 345 TFEU). Customers associate a distinct, unmistakable service profile with these brands. In a certain sense, the brands also reflect the self-image of the associated groups, thus constituting an essential part of the group structure. That said, it must be taken into account regarding the "Sparkasse" label that this label does not merely constitute a company trade

<sup>712</sup> §§ 21(2), 22 of the Charter of LBBW; § 12(1) No. 1-4 of the Charter of LRP.

<sup>713</sup> ECJ, Judgment of 25. November 1971, 22/71, Béguelin, [1971] E.C.R. 949, para. 29; Judgment of 20 September 2001, C-453/99, Courage and Crehan, [2001] E.C.R. I-6297, paras. 22, 24.

<sup>714</sup> See European Commission, Communication on the application of the European Union State aid rules to compensation granted for the provision of services of general economic interest, OJ C 8, 11 January 2012, p. 4, paras. 9, 11-12.

<sup>715</sup> ECJ, Judgment of 6 April 1995, C-241/91 P and C-242/91 P, RTE and ITP ("Magill"), [1995] E.C.R. I-743, para. 52 (at the end).

mark, but that it is also protected specifically under § 40 KWG. The label takes account of the confidence of the public in the savings banks' activities, thereby indicating a distinct prudential profile of the institutions using the "Sparkasse" label. This adds to the legitimacy of the savings banks and giro associations' measures to protect the label if third parties use the label without offering credit services for the purpose of fulfilling a public mandate. If third parties are active in that way, however, it can be necessary to allow them the use of the "Sparkasse" label.<sup>716</sup> In that case, it would be problematic under competition law if the associations raised any obstacles (Article 102 TFEU).

**1899.** In so far as the associations acquire strategic ownership interests in group members to protect the associated group structure against third-party infiltration, they principally act in accordance with competition principles if the association members remain free to bid themselves for the respective ownership interest.<sup>717</sup> In addition, however, the limits imposed by Article 102 TFEU have to be taken into account, meaning that, for instance, the acquisition of an ownership interest in a savings bank can be abusive if it contributes to (additional) foreclosure in the interest of the neighbouring savings banks.<sup>718</sup> Under the circumstances, Article 102 TFEU may also come into play where an association withdraws group benefits from individual group members (e.g., excluding them from the institutional security mechanism).

#### ***4.3.3.4 The role of the central banks and the group institutions active above the regional level***

**1900.** The role of the central banks of the savings bank group and the cooperative group (DekaBank/DZ-Bank, regional central banks/giro centres) and of the other relevant group undertakings on the national level or the *Länder* level (e.g., brokers, building societies, insurances) must likewise be assessed in a differentiated way.

**1901.** The central banks, in particular, fulfil various functions within the associated groups, where it may sometimes be questionable to what extent they are even active on a market. This circumstance must be taken into account in the competitive assessment. On the basis of the information available, it appears reasonable to distinguish the following functions:

- central bank activities in a narrower sense, i.e., support of payment settlement and liquidity clearing,
- support of the fulfilment of public service obligations (savings bank group),
- the provision of liability guarantees,
- the provision of products for refinancing/investment purposes or for the distribution through the savings or VR banks (e.g. funds), and
- the provision of advisory services.

#### ***Central banking activities in the narrower sense***

**1902.** Regarding central banking activities in the narrower sense, it is unclear whether there is any market activity. In that regard, the European Commission guidelines provide a starting point, requiring an assessment of whether the cooperation between the central banks and the subordinate group institutions restricts competition that would have existed without that cooperation.<sup>719</sup> It is,

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<sup>716</sup> See European Commission, press release of 6 December 2006, IP/06/1692; Federal Ministry of Finance, press release No. 146/2006 of the same day.

<sup>717</sup> See FCO, Activity Report 2005/06, pp. 158-159.

<sup>718</sup> See ECJ, Judgment of 21 February 1973, 6/72, Continental Can, [1973] E.C.R. 215, paras. 25-26, 29.

<sup>719</sup> European Commission Notice, Guidelines on the application of Article 81(3) of the Treaty, OJ C 101, 27

however, questionable whether the settlement and booking systems of the three banking groups (giro circles) stand in competition with each other. The central banks of the savings bank group act upon a statutory mandate. Only the central banks of the other banking groups provide a service to their members which satisfies demand and regarding which competition would in principle be possible.

**1903.** That being said, the question can be left open because, based on the information available, there is at least no evidence giving rise to competitive concerns. The central bank activities, as such, should give rise to significant efficiency benefits. In so far as the central banks support the group members in the payment settlement and provide cash clearance, they fulfil functions that must be carved out of the group institutions because they exceed the capabilities of an individual bank.<sup>720</sup> According to the self-image of the groups' central banks, they also align their activities specifically with the interests of the groups' member institutions. In that way, they ensure the productive efficiency of the associated groups and enable the member institutions to participate fully in competition despite a relatively small company size.

**1904.** Even beyond the central bank activities in a narrower sense, it should to a certain extent be an immanent group feature that the central banks take the interests of the savings or VR banks into account in their own business activities, and that they provide support.

### *Support of the fulfilment of public service obligations (savings bank group)*

**1905.** In principle, no concerns arise if the *Landesbanken* support the savings banks in the fulfilment of their public service obligations. This applies at least if the public mandate is limited to non-economic purposes. In that case, the support is not market-oriented. Such support should generally also be part of the self-image of the *Landesbanken*, and it is generally possible without requiring a competitively relevant coordination of conduct.<sup>721</sup>

### *Provision of liability guarantees*

**1906.** The provision of liability guarantees (letters of comfort) provides good credit standing to the benefiting group members. However, this is a unilateral central bank action that generally does not give rise to competitive concerns.<sup>722</sup>

### *Provision of products for refinancing/investment purposes or for distribution*

**1907.** By providing products for refinancing/investment purposes or for the distribution through the savings or VR banks, however, the central banks also provide significant market-oriented services within a contractual framework.<sup>723</sup>

**1908.** These contractual agreements are fully subject to German and European competition law.<sup>724</sup> In that regard, no limitations follow from the laws on the *Landesbanken* and the savings banks (cf. Article 106(2) TFEU) or from the cooperative furtherance principle.

April 2004, p. 97, para. 18 No. 1.

<sup>720</sup> In that regard, already the existence of a service within the distribution chain may be questioned, see Article 1 of Regulation 19/1965, OJ L 36, 6 March 1965, 533 (“for resale”).

<sup>721</sup> See, e.g., Article 2(2)(1) BayLBG: “Through its activities, the bank supports the Free State of Bavaria and its municipal institutions including the savings banks in the fulfilment of public tasks” [unofficial translation of “*Die Bank unterstützt durch ihre Geschäftstätigkeit den Freistaat Bayern und seine kommunalen Körperschaften einschließlich der Sparkassen in der Erfüllung öffentlicher Aufgaben*”].

<sup>722</sup> The prudential assessment may be different; see para. 1587 above (*on the comparable problem of silent partnership contributions*).

<sup>723</sup> Bayern LB, Annual Report 2011, p. 56; Nord/LB, Annual Report 2011, p. 89; DZ Bank, Annual Report 2012, p. 18.

<sup>724</sup> See Article 3 of Regulation 1/2003 in so far as cases of relevance for the internal market are concerned.

**1909.** Exclusive distribution agreements should exist where the central banks provide products for exclusive distribution to the savings banks and the VR banks, for example investment funds, currencies, or noble metals.<sup>725</sup> The distribution of building savings plans of the groups' building societies, and the distribution of group insurances probably have to be assessed in the same way.

**1910.** It is questionable whether these agreements are exempted from the cartel prohibition under Regulation No. 330/2010 (see Articles 2(2), (3) Reg. 330/2010). Even if this is not the case, however, efficiencies can justify the exclusive distribution agreement in the individual case. In that regard, it is important that the central banks and the supra-regional group institutions and companies take over product development for the group members where the development by individual institutions would not be economical.<sup>726</sup> However, a relatively strict assessment may be justified given the fact that the group members also satisfy their demand in the relevant products essentially within the group.<sup>727</sup> In relation to investment funds products, insurances, and possibly building savings plans for private customers, however, it must be taken into account that in particular the new business in the retail banking context requires a substantial amount of advice as the products are relatively complex consumer products binding the investment over a longer period. Thus, the distributing banks must know the products quite well in order to ensure the high quality of their advice. This should generally speak for the justification even of relatively close cooperation on the distribution level, depending on the individual circumstances.

**1911.** A more critical view may be warranted where the supply or distribution of associated group products within the group or to customers outside the group does not require particular advice. This should be the case for relatively simply structured investment products and the distribution of currencies, noble metals, and the like. In that respect, group-only distribution has the potential to contribute to increased foreclosure between the associated groups.<sup>728</sup>

### *Provision of advisory services*

**1912.** Concerning the provision of advisory services by the central banks and other group companies, a distinction is necessary. Advisory services relating to central bank services in a narrower sense, or the support of group members in the fulfilment of their public service obligations should regularly not be relevant from a competition perspective or at least be justified through the efficiencies associated with the central bank activity. In contrast, advisory services in the context of distribution must be assessed in the individual case.

#### *4.3.3.5 Other coordination among associated group members*

**1913.** The Monopolies Commission is concerned that competition in the associated groups is not only restricted through the cooperation within the associations and the distributory relations, but that the market behaviour of the group members and in the competition between the groups is partly not independent, which may give rise to additional restraints.

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<sup>725</sup> In that context, the savings/VR banks do regularly not act as agents in terms of competition law either as they bear risks of their own (e.g., regarding prospectus liability), see European Commission, Guidelines on vertical restraints, OJ C 130, 19 May 2010, p. 1, para. 16; particularly, with regard to prospectus liability, see also BGH, Judgment of 21 March 2006, XI ZR 63/05, WM2006, 851; LG Hanau, Judgment of 12 May 2011, 4 O 1138/10 (citation: Juris).

<sup>726</sup> See European Commission Communication, Guidelines on the applicability of Article 101 TFEU to horizontal co-operation agreements, OJ C 11, 14 January 2011, p. 1, paras. 150 ff., especially paras. 183 ff.

<sup>727</sup> See Article 1(1) lit. d of Regulation 330/2010; European Commission, Guidelines on vertical restraints, OJ C 130, 19 May 2010, p. 1, para. 162.

<sup>728</sup> ECJ, Judgment of 28 February 1991, C-234/89, *Delimitis v. Henninger Bräu*, [1991] E.C.R. I-935, paras. 19 ff.

**1914.** In that regard, however, it is necessary to take into account that potential coordination between the associated group members is pre-determined to a large extent by group-related commonalities and the work division imposed by law or cooperative principles. This suggests that the group members will cooperate in the first place with each other and only in the second with non-group institutions, for example, in the underwriting business. In part, the central banks depend on the infrastructure of the groups' retail banks (savings banks, VR banks) and will, thus, tend to concentrate their business on markets on which such dependencies do not exist (corporate banking, foreign markets). On the other hand, even large savings banks will in doubt refrain from developing investment or complex building savings products and source or provide the products supplied by other member institutions of the savings bank group as their own development of such products is contrary to their business focus, which aims at satisfying local or regional demand. In the same way, it must be assumed that the group member institutions at the same level will cooperate to jointly entice customers away from competitors outside the group.<sup>729</sup> Such behaviour is unobjectionable if the limits of competition law are being respected.

**1915.** That said, indications exist that in particular in the savings bank group, market and customer sharing may have developed which exceeds the limits of the law and is not easily reconcilable with competition law. The savings banks interpret the associated group principle and the regional principle flexibly during their own business activities, but they insist on an anticompetitive enforcement of the two principles partly towards other group members (e.g., the *Landesbanken*) and in particular towards their competitors, using the principles to deliberately seal the group off and to foreclose competition.

**1916.** For example, the savings banks generally react flexibly to demand without referring customers to other members of the associated group from the outset (passive business)<sup>730</sup>. If business, for example, exceeds the capacity of individual savings banks, they enter into underwriting agreements with other savings banks or the *Landesbanken*. Customers can keep their account at "their" savings bank even after moving away from the municipality or entrust both the savings bank at their place of residence and at their work place.

**1917.** In contrast, the savings banks seek to counter competitive advances within the group to the extent possible, and they also refrain from active customer marketing in the territory of neighbouring savings banks, which would increase the competitive pressure on these institutions (active business).<sup>731</sup> They justify this conduct with the argument that work division and no competition exists between the group members. With this argument, they also continue to fend off attempts to open up the associated group or its institutional security mechanisms and rights to external competitors.

**1918.** Furthermore, in the Monopolies Commission's view, indications exist of regionally restricted parallel behaviour of the savings banks on the one hand and the cooperative banks on the other hand (VR banks, Sparda banks), the reasons for which could not be identified so far.<sup>732</sup>

When assessing the market situation in retail banking, the Monopolies Commission discovered that the savings banks' and the cooperative banks' account models sometimes resembled each other in a remarkable way, and that also the prices and products of both associated groups in local retail banking were sometimes remarkably aligned with each other. Consequently, it compared in its own regional empirical survey, among others, the current account conditions – monthly current account fees and the

<sup>729</sup> See, e.g., Lebert, Sparkassen jagen Schmidt-Bank-Kunden, FTD, 7 April 2004.

<sup>730</sup> See European Commission, Guidelines on vertical restraints, OJ C 130, 19 May 2010, p. 1, para. 51.

<sup>731</sup> See *ibid.*, para. 51; the situation is different where competition between members of the associated groups and outside banks is concerned, see again Lebert, Sparkassen jagen Schmidt-Bank-Kunden, FTD, 7 April 2004.

<sup>732</sup> Regarding the situation between the savings banks and the VR banks, see broadly FCO, Decision of 21 October 2010, B4-45/10, Sparkasse Karlsruhe/Sparkasse Ettlingen, paras. 96, 99, 106, 113-116; Decision of 28 February 2012, B4-51/11, Haspa/KSK Lauenburg, paras. 134, 139-140.

interest on overdraft loans – of both the savings banks and the VR banks.<sup>733</sup> This survey produced the following results:

- On the basis of a conservative interpretation of the statistical test results, indications existed for the congruence of the savings banks' and the VR banks' account conditions. For lack of current data on relevant influencing elements, it could not be established so far to what extent the savings banks' strong market position may have been the reason.
- Indications for the congruence of the account conditions of the savings banks and large private banks were not identified.

The parallel behaviour of banks belonging to the two associated groups would not be impermissible if it resulted from the market conditions (so-called implicit collusion). Still, it could encourage cartelisation depending on the market conditions and must therefore be monitored.

#### **4.3.4 Intermediate result**

**1919.** The Monopolies Commission sees a need for clarifying whether the associated group structures have consolidated in the savings bank group at least at the regional level and whether distinct economic entities have developed, which would require a fundamental re-assessment of the associated groups in competition. The assessment of group cooperation from a competitive perspective is difficult. The opacity of intra-group cooperation, as seen from outside, poses significant problems regarding the assessment. This holds both for the cooperation in the savings bank group as well as – at least to a lesser extent – for the cooperation in the cooperative group.

**1920.** The activities of the associations should to a large extent be compatible with Article 101 TFEU, § 1 ARC due to working group principles or economic efficiencies (e.g., the management of the institutional guarantee association, the development of business concepts). That said, for example, joint marketing measures particularly in the savings bank group are subject to a strict assessment as the participating savings banks should frequently have relatively high market shares (> 15%). Where the associations develop common concepts and business strategies, this can be problematic in particular if this is only intended to improve the earnings situation or the market position of the associated group members, without being linked to efficiencies or being necessary for meeting objectives that are permissible by law. The same holds for the exchange of information or experience in group committees or through the auditing bodies/associations. Particularly grave concerns arise from the indications of a “work division” based on customer sharing within the savings bank group. Concerns, however, also arise from the cooperation in the *Landesbanken* boards of advisers or of special advisers, to the extent that this cooperation requires price-related coordination at the level of the savings banks. Measures of the associations to protect the group structure may not restrict the freedom of the association members without justification, but they may also warrant review in relation to third parties based on abuse-of-dominance principles.

**1921.** The role of the central banks and the supra-regional group institutions must equally be assessed in a differentiated way. Based on the information available, the support of group undertakings in payment settlement and liquidity clearing does not raise competitive concerns, nor does the *Landesbank* support for the savings banks when they fulfil their public mandate or the provision of liquidity guarantees. The provision of products for refinancing/investment purposes or for distribution, though, may have to be viewed critically to the extent that it is an exclusive distribution arrangement where the group members satisfy their own demand primarily within the group and the

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<sup>733</sup> See Appendix C and, concerning other Monopolies Commission analyses in this context already para. 1879 above.

products are not complex and do not require a substantial amount of advice (contrary, e.g., to the new business with investment fund products).

**1922.** The other coordination of the group members should be monitored more closely, the more so as the savings banks seem to apply and to enforce the associated group principle and the regional principle in a way that raises competitive concerns. In addition, indications exist for at least implicit collusion between the savings banks and the cooperative banks.

#### ***4.4 Competition policy assessment of the “regional principle” in the savings bank acts***

**1923.** The Monopolies Commission advocated the abolishment of the restrictions on the business territory established through the regional principle, which is enshrined in the savings bank acts. These provisions violate EU law because they restrict the business territory of the savings banks, and thus limit the savings banks’ liberty to develop their business policy on their own, and to enter into competition with each other and with other banks outside their territory to acquire new customers. In essence, it is a statutory market allocation rule. However, there is no reason why market allocation based on a statute should be permissible for savings banks whereas private institutions would not be permitted to agree on the same market allocation.

##### ***4.4.1 Distinction between the commercial strategy and statutory demand***

**1924.** The Monopolies Commission stresses that it does not reject the regional principle as an element of the savings banks’ and the cooperative banks’ business strategy. In that respect, it also agrees with the Council of Economic Experts.<sup>734</sup> It is, however, necessary to distinguish between the regional principle as an element of individual strategy, and statutory demand.

**1925.** As an element of individual business strategy, the regional principle is innocuous particularly for smaller institutions that are limited in their growth through the given cost structure. Here, it follows from a risk assessment which makes the institutions enter only those markets which they can cope with relatively well. On the one hand, that approach is advantageous because the banks are subject to less competitive pressure given that they do not compete with each other. On the other hand, it is also disadvantageous because the banks cannot use the market opportunities potentially linked to expansion. This makes sense as long as such an expansion would be associated with excessive costs and risks for the relevant institutions.

**1926.** However, the larger and more profitable the banks are, the more the disadvantages of the regional restrictions come to the fore, and the more the abstention from expansion needs to be justified. In that case, insisting on such a restriction is no market-compliant conduct.

**1927.** That being said, the regional principle has been laid down for public savings banks in nearly all *Bundesländer* by law.<sup>735</sup> The exceptions are Hamburg, Hessen and Schleswig-Holstein, where privately constituted free savings banks (*Freie Sparkassen*) (or – Hessen – their legal successors) still exist, which sometimes are of a considerable size. In Hamburg, no savings bank act has been passed;

<sup>734</sup> Council of Economic Experts, *Das deutsche Finanzsystem. Effizienz steigern – Stabilität erhöhen*, Expertise of 17 June 2008, paras. 3, 16-17, 248.

<sup>735</sup> § 6(1) SpG BW (“primarily” [“*vorrangig*”]), see also § 2(2), (3) SpG BW; Articles 2(1)(1), 20 BaySpkG in conjunction with § 2 SpkO; § 1(2) BerlSpkG; § 5 BrdbgSpkG; § 3 (“primarily” [“*vorrangig*”]) and § 5 BremSpkG (though no implementing regulation exists), likewise § 5 of the Interstate Agreement of 23 July 2012 on Bremer Landesbank Kreditanstalt Oldenburg – Girozentrale; § 5 SpkG MV in conjunction with § 3 SpkVO MV; § 4(2) NSpG; § 3 SpkG NW; § 2(1) SpkG RP (“primarily” [“*vorrangig*”]); § 5 SachsSpkG; § 5 SpkG-LSA in conjunction with § 3 SpkVO; § 2 (1)(1) in conjunction with § 3 SSpG (“primarily” [“*vorrangig*”]); § 6 ThürSpkG. In Federal law, see also § 40(1) No. 3 KWG.

in Hessen and Schleswig-Holstein, the acts refer to the savings banks' business territory without restricting it.<sup>736</sup> In the other cases, the mandatory business territory of public savings banks is generally the territory of their municipality. The savings banks are meant to act only or mainly in that territory for business purposes (in particular when handing out loans), and on principle, it is there that they are only allowed to acquire branches or, as the case may be, any company stakes. The supervisory authorities may grant exceptions. In many savings bank regulations and by-laws, the statutory regional principle is repeated and the savings banks' business territory is delineated more precisely.

**1928.** In that regard, a certain parallel is apparent to the case of the German lottery (Deutscher Lotto- und Totoblock), which was addressed in the XIXth Biennial Report.<sup>737</sup> In that case, the German lottery providers and sports bookmakers had agreed to distribute the lotteries and sports bets which they hosted only within the *Land* that had granted them a licence (so-called regionality principle). The Federal Cartel Office considered this obligation to constitute an infringement of competition law and rejected the claim that the providers' and bookmakers' conduct was mandated by the then-existing Interstate Lottery Agreement. For the relevant provision of the Lottery Agreement itself violated the Member States' obligation to refrain from all measures that would impair the effectiveness of the EC competition rules.<sup>738</sup> The Federal Court of Justice in essence upheld the Office's finding, ruling that

“any territorial restriction [through] State measures [would be] immaterial as such provisions would, by reinforcing the competition-restricting effects of the Block Agreement [entered into between the lottery providers], violate Article 10 EC in conjunction with Article 81 EC [= Article 101(1)(c) TFEU in conjunction with Article 4(3) TEU] and could, hence, be ignored.”<sup>739</sup>

As the provisions to which the Federal Cartel Office had objected had meanwhile been amended or deleted, however, nothing any longer supported the supposition that they continued to require or favour or reinforce the effects of an anticompetitive market sharing.<sup>740</sup>

**1929.** The competitive assessment of lottery-law regionality is the same to a large extent, and in the outcome, as the assessment of the regional principle in the savings acts. The underlying provisions cannot be interpreted in accordance with EU law. The requirement that the savings banks “are to” operate commercially “only” or “mainly” in the specified territory is not open to interpretation. In such a case, EU law mandates that such provisions do not apply to the extent they run counter to Union law. It does not matter that the statutory regional principle or its constitutional foundations are older than the applicable EU law.<sup>741</sup>

**1930.** The DSGV argues that the facts are completely different in this case as the lottery-law regionality principle rested on an antecedent agreement between undertakings. The following assessment, however, is based on a provision where the difference highlighted by DSGV is of no relevance.<sup>742</sup>

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<sup>736</sup> See § 1(3) HessSpkG; § 2 SpkG SH. However, based on the law and a model charter, the regional principle principally applies to the public-law savings banks in Schleswig-Holstein; see § 3(2) SpkG SH in conjunction with §§ 12 ff. of Model Charter 2023.12 in the version of 2 December 2013.

<sup>737</sup> FCO, Decision of 23 August 2006, B 10 – 148/05, DLTB; see also Monopolies Commission, XIXth Main Report 2010/2011, Strengthening Competition in Retailing and Services, Baden-Baden 2012, paras. 36 ff.

<sup>738</sup> FCO, Decision of 23 August 2006, B 10 – 148/05, DLTB, p. 10 and paras. 519 ff. (especially paras. 577 ff.); see also pp. 12-13., paras. 713 ff. concerning the rules in the Interstate Agreement on Regionalisation about the statutory allocation of earnings.

<sup>739</sup> BGH, Decision of 14 August 2008, KVR 54/07, Lottoblock, WuW/E DE-R 2408, para. 91.

<sup>740</sup> BGH, Decision of 14 August 2008, KVR 54/07, Lottoblock, WuW/E DE-R 2408, paras. 135-137.

<sup>741</sup> ECJ, Judgment of 9 September 2003, C-198/01, CIF, [2003] E.C.R. I-8079, para. 48.

<sup>742</sup> Regarding the compatibility with the market freedoms, see Frenz, *Handbuch Europarecht*, Band 1, 2nd Ed. 2012, paras. 247 ff.

#### ***4.4.2 Prohibition of anticompetitive measures in the case of public undertakings (Article 106(1) TFEU)***

**1931.** The statutory regional principle runs foul of Article 106(1) TFEU. Under that provision, it is prohibited, in the case of public undertakings, to enact or maintain in force any measure contrary to the rules contained in the Treaties, in particular to the competition rules (Articles 101 ff. TFEU). The savings banks are public undertakings in terms of that provision.<sup>743</sup>

**1932.** The regional principle is a measure the enactment of which runs counter to the prohibition on cartels in Article 101(1)(c) TFEU. The Member States enact a “measure contrary” to the prohibition on cartels by making public undertakings participate in agreements or concerted practice restricting competition, or where they mandate a compulsory cartel. That provision reflects the equal treatment between public and private undertakings, for it hinders the State from using its sovereign powers in favour of public undertakings in order to create a market result that any undertakings would be prohibited to produce through private agreement.

**1933.** The statutory enactment of the regional principle mandates compulsory cartelisation. Within the confines of the statute establishing the regional principle, the savings banks’ conduct is no longer independent, but is concerted (by law). The savings banks generally desist from actively attracting customers from outside their business territory. That compulsory concertation is not less existent due to a certain scope of interpretation that the savings banks benefit from under the statutory rules.

**1934.** A measure contrary to the prohibition on cartels does not presuppose either that an agreement between undertakings or a concerted practice of such undertakings can be traced back to a given State measure. For the measure takes the place of such agreement or concerted practice, without being complementary or accessory. Thus, it is of no relevance either that the enactment of the regional principle leaves a scope of interpretation to the savings banks which they use – however, in a coordinated fashion – by desisting from attracting customers from outside their business territory, but at the same time to some extent satisfying the demand of customers who call on them from outside the business territory (connection principle).

**1935.** Another interpretation of the relevant provisions would imply that the “measures contrary” to the cartel prohibition could not be “enacted” by a Member State that sets them out by law. For within the confines of the statutory provisions, the relevant undertakings do not retain any ability at all to manipulate their behaviour and, thus, to enter into a cartel agreement. The consequence would be that one misses the purpose of the European rule that private and public undertakings should be treated equally also and in particular where no liability of the public undertakings themselves exists due to the use of sovereign measures. Moreover, a Member State would violate EU law by favouring or retroactively taking up the undertakings’ concerted practice, but not by mandating such conduct in advance. That differentiation does not appear necessary, not can it be justified regarding competition.

**1936.** Consequently, when determining whether a measure is contrary to the competition rules, European jurisprudence places high significance on the effects of the measure, i.e., on whether the relevant public undertakings cannot but violate the competition rules by following the measure.<sup>744</sup> Thus, it constitutes a measure contrary to the cartel prohibition, for instance, where a Member State mandates the application of pre-defined prices as a condition to a concession contract.<sup>745</sup> The adherence to market sharing in accordance with the regional principle must be appraised accordingly.

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<sup>743</sup> See Article 2(1) lit. a and b of Directive 2006/111/EC, OJ L 318, 17 November 2006, p. 17.

<sup>744</sup> ECJ, Judgment of 23 April 1991, C-41/90, Höfner and Elser, 1991 E.C.R. I-1979, head note 2 and para. 27 (though with reference to Article 86 EEC = Article 102 TFEU); informative also Attorney General Van Gerven, Opinion of 16 October 1991, C-48 and C-66/90, Dutch Post, [1992] E.C.R. I-565, paras. 38-39.

<sup>745</sup> ECJ, Judgment of 4 May 1988, 30/87, Bodson, 1988 E.C.R. 2479, para. 34.

**1937.** In German legal doctrine, it is accepted correspondingly that a Member State can enact a measure contrary to the cartel prohibition by mandating public undertakings to adhere to a given behaviour by forming a compulsory cartel by law.<sup>746</sup> It is pointed out in addition that the conduct of the public undertakings of Member States or their regional partitions (e.g., *Länder*, municipalities) can be attributed to Member States, the more where such undertakings act based on sovereign empowerment, see Article 106(1) TFEU.<sup>747</sup> Accepting this as correct, a measure within the meaning of that provision is enacted or maintained not only through the enactment of the regional principle, but also when the savings banks apply the statute.

**1938.** The regional principle restricts competition between the savings banks as it limits by statute the savings banks' freedom to expand their business beyond their respective business territory. This is a hardcore restriction, that is, a particularly serious cartel infringement. Such a restriction is appreciable.<sup>748</sup>

**1939.** The restriction of competition cannot be disputed. It cannot be denied as regards competition nor as regards the restriction. Competition potentially subject to a restriction is not non-existent because the savings banks are mostly active on regional markets.<sup>749</sup> The regional principle has the purpose of artificially hindering the merging of business territories.<sup>750</sup> A restriction of competition does not fall away given that the savings banks are not placed in a better position than their competitors, but that the regional principle “[t]o the contrary puts a restraint on the commercial activities of the savings banks”.<sup>751</sup> It is exactly this fact that constitutes the restriction. An advantage to the savings banks' benefit is not required.

**1940.** The restriction of competition is not immaterial either. The DSGVO claims that the regional principle strengthens competition between the associated banking groups and the private banks. If this is accepted as a basis, the regional principle may indeed safeguard the business foundations of the savings banks association and may stabilise it.<sup>752</sup> That said, the associated group does not benefit from a “company group privilege” exempting it from the competition rules. Beside competition across the entire system, competition between the association members is protected as well. The European cartel prohibition does not provide for a balancing of the negative and positive competition effects in order to assess a restraint on competition either (rules of reason approach). Whenever a restriction of competition exists, the positive effects on competition can only speak for a justification.

**1941.** In addition, de facto considerations here militate against a preponderance of the positive competition effects of the regional principle. The DSGVO views competition as being strengthened in

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<sup>746</sup> Emmerich in: Dausen, Handbuch des EU-Wirtschaftsrechts, Supp. 20, Section H.II, para. 109; further, see Kapp in: Frankfurter Kommentar, Supp. 72, September 2010, Art. 106 para. 95; Mestmäcker/Schweitzer in: Immenga/Mestmäcker, 5th Ed. 2012, Art. 106 Abs. 1 AEUUV, paras. 92, 101; Wernicke in: Grabitz/Hilf, Supp. 43, March 2011, Art. 106 AEUUV para. 59; Weiß in: Callies/Ruffert, AEUUV, 4th Ed. 2011, Art. 101 para. 15.

<sup>747</sup> Wernicke in: Grabitz/Hilf, Supp. 43, March 2011, Art. 106 AEUUV para. 60.

<sup>748</sup> European Commission, Notice on agreements of minor importance which do not appreciably restrict competition under Article 81(1) EC (de minimis), OJ C 368, 22 December 2011, p. 13, para. 11; equally now Notice on agreements of minor importance which do not appreciably restrict competition under Article 101(1) of the Treaty on the Functioning of the European Union (De Minimis Notice); C(2014) 4136 final, paras. 2, 13.

<sup>749</sup> FCO, Decision of 28 February 2012, B4-51/11, Haspa/KSK Lauenburg.

<sup>750</sup> See European Commission Notice, Guidelines on the application of Article 81(3) of the Treaty, OJ C 101, 27 April 2004, p. 97, para. 21 (restriction by object); European Commission, Decision of 23 November 1985, IV/30.907, Peroxyd-Produkte, OJ L 35, 7 February 1985, p. 1, paras. 10 ff.

<sup>751</sup> DSGVO, Submission, “Zur Vereinbarkeit des sparkassenrechtlichen Regionalprinzips mit dem Europarecht und seinem ökonomischen Nutzen”, received on 26 September 2013 (Submission of 26 September 2013), p. 4.

<sup>752</sup> Cf. DSGVO, Submission of 26 September 2013, p. 7 (“Sicherung und Verbesserung der eigenen Geschäftsgrundlagen”).

particular because the regional principle ensures that a second bank shows local presence aside from the cooperative banks, which are regionally rooted as well.<sup>753</sup> First, the mere existence of a second bank does not necessarily imply the presence of competition. To the contrary, a presumption exists against the existence of vibrant competition where one supplier holds substantial market shares (> 40%)<sup>754</sup>. The Federal Cartel Office has concluded in a number of cases that the savings banks hold such shares on a number of markets.<sup>755</sup> The savings banks themselves claim that they are the market leaders in many areas. A market leader, however, does not have many incentives, in contrast to its competitors, to actively engage in competition to gain further customers. This holds in particular where – as is frequently the case on the relevant markets – the next competitors hold considerably lower market shares.<sup>756</sup> Second, no reason exists for the assumption that the savings banks would cease to be local competitors without the regional principle. Just to the contrary, it must be assumed that individual savings banks would actively engage to attract customers in other territories absent any territorial restraint. They would engage in additional competition with the savings banks that are already present. Third, there is no basis for the assumption that a regional presence of the savings banks is necessary to ensure that a competitive alternative exists to the cooperative banks. The cooperative banks are exposed to competition also by other banks than the savings banks. Postbank, in particular, is another supplier that shows frequent local presence and that fosters vigorous competition particularly in the retail business.

**1942.** A restriction of competition cannot be doubted in view of the entirely fragmented German banking market either. The DSGVO calls the German market the most competitive market within the EU given its low concentration.<sup>757</sup> Low market concentration, however, is not equal to the presence of much competition. It can also point to structural peculiarities. The German banking market is marked particularly by the two associated groups of the savings banks and the cooperative banks, whose members only engage in competition with each other to a limited extent.<sup>758</sup>

**1943.** The restriction of competition associated with the regional principle is also capable of affecting trade between the Member States. A sovereign measure or a competition restriction that covers an entire Member State is typically capable of having an effect on trade.<sup>759</sup> The regional principle applies at least in the *Bundesländer* that border other Member States, thus partitioning and walling off the German market along the borders.<sup>760</sup>

**1944.** The capability of affecting trade cannot be put in doubt in the present case because the regional principle affects only Germany or individual German regions. The regional principle hampers German savings banks, among others, from actively attracting customers in other Member States and

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<sup>753</sup> DSGVO, Submission of 26 September 2013, p. 6.

<sup>754</sup> European Commission, Communication, Guidance on the Commission's enforcement priorities in applying Article 82 of the EC Treaty to abusive exclusionary conduct by dominant undertakings, OJ C 45, 24 February 2009, p. 7, para. 14; equally § 18(4) ARC in German law.

<sup>755</sup> Most recently FCO, Decision of 28 February 2012, B4-51/11, Haspa/KSK Lauenburg; Decision of 21 October 2010, B4-45/10, Sparkasse Karlsruhe/Sparkasse Ettlingen.

<sup>756</sup> See ECJ, Judgment of 14 February 1978, 27/76, United Brands, [1978] E.C.R. 207, para. 111/120; equally § 18(3) ARC in German law ("in relation to its competitors").

<sup>757</sup> DSGVO, Submission of 26 September 2013, p. 7.

<sup>758</sup> The associated groups combine a large share of the balance sheet total of German banks; see Deutsche Bundesbank, Statistische Beihefte, Bankenstatistik 2013.

<sup>759</sup> ECJ, Judgment of 19 February 2002, C-35/99, Arduino, [2002] E.C.R. I-1529, para. 33; European Commission Notice, Guidelines on the effect on trade concept contained in Articles 81 and 82 of the Treaty ("Guidelines on the effect on trade"), OJ C 101, 27 April 2004, p. 81, paras. 77-78.

<sup>760</sup> Where individual savings bank acts are phrased openly (as is the case, e.g., in Saarland, Schleswig-Holstein), the savings banks seem at least to interpret them like in the other *Länder*. It can here be left open whether an effect on trade exists under Article 106(1) TFEU because the savings banks' conduct would otherwise not have to be assessed under Article 106(1) TFEU, but under Article 101(1) TFEU. Also in this regard, there would be an effect on trade.

from actively selling financial products to them. Such a competitive restraint operating across the borders has an effect on trade typically also where the relevant undertakings have their seat in the same Member States.<sup>761</sup>

**1945.** An effect on trade, however, also exists in the opposite direction. As said above, it must be assumed that the savings banks would engage in more vigorous competition among themselves absent the regional principle. This additional competition, adding to the competition between the savings banks and the private and cooperative banks, would make the savings banks to a larger extent than at present pass on benefits achieved in competition to the consumers, and not retain them to reap additional profits. At present, the ability of the savings banks to retain such additional profits raises the entry barriers for foreign competitors.

**1946.** It is no counterargument that foreign competitors can in principle open branches within the business territories of the savings banks, and that they actually do that to a certain extent at least in regions close to an urban centre.<sup>762</sup> The foreign competitors are aware that the savings banks, due to the regional principle, do not stand in competition with each other, and the regional principle consequently has an effect on trade irrespective of whether the savings banks actually use their competitive advantage to the detriment of their competitors.

**1947.** The effect on trade associated with the regional principle is also appreciable and, thus, sufficiently significant. In that regard, it does not matter – contrary to what the DSGV claims – that the regional principle has regional or merely local effects. Likewise, it does not matter that the mainly affected markets are regional and that only a relatively small amount of turnover may be affected on the regional or local level.<sup>763</sup> It is decisive that the statutory provisions have a cumulative effect across the individual regions, and that they do not relate to individual products, but to the entire product portfolio of the savings banks, regardless of the potentially affected turnover in the individual case. In addition, it must be taken into account from an economic and a legal perspective that the savings banks have substantial market power, which is increased by the possibility to cooperate within the associated group.<sup>764</sup> Therefore, the provisions on the statutory regional principle contribute significantly to the partitioning of markets along the German borders.

**1948.** Finally, the regional principle is a sovereign measure “in the case of” the savings banks. In that respect, it suffices that the statutory provision relates only to the savings banks.<sup>765</sup> Other municipal undertakings are not required to adhere to the regional principle.

**1949.** The DSGV does not view the regional principle as a measure “in the case of” the savings banks because it is an expression of a general principle of public and administrative law. That, however, is not convincing. A constitutional principle can apply only to the public entity controlling the municipal undertakings. The municipal laws likewise only limit the controlling public entities and not the operating municipal companies in their commercial behaviour. Consequently, it is unclear from which source a general principle reflecting the regional principle from the savings bank acts could at all be derived. The legislatures in the German *Länder* are moreover in any case bound to respect the

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<sup>761</sup> European Commission, Guidelines on the effect on trade, OJ C 101, 27 April 2004. p. 81, para. 63.

<sup>762</sup> Cf. DSGV, Submission, Stellungnahme zu den vorläufigen Beurteilungen der Monopolies Commission betreffend die Vereinbarkeit des sparkassenrechtlichen Regionalprinzips mit dem EU-Wettbewerbsrecht, 30 January 2014 (Submission of 30 January 2014), paras. 39 ff.

<sup>763</sup> Cf. DSGV, Submission of 30 January 2014, paras. 44-47.

<sup>764</sup> European Commission, Guidelines on the effect on trade, OJ C 101, 27 April 2004. p. 81, paras. 49, 53. ECJ, Judgment of 11 July 1989, 246/86, *Belasco*, [1989] E.C.R. 2117 (see, particularly, paras. 47, 51), as quoted by DSGV, Submission of 30 January 2014, para. 48, is compatible with these principles.

<sup>765</sup> See ECJ, Judgment of 4 May 1988, 30/87, *Bodson*, [1988] E.C.R. 2479, paras. 3-4, para. 7 (Question 2) and paras. 16 ff. (law concerning funeral parlours); Attorney General Lenz, Opinion of 11 January 1994, C-387/92, *Banco de Credito Industrial*, [1994] E.C.R. I-877, paras. 35 ff. (law concerning banks).

European competition rules.<sup>766</sup> Likewise, a “general principle” manifested in the regional principle would only be relevant within the confines of EU law.

#### 4.4.3 *No competitive justification*

**1950.** The statutory regional principle cannot be justified on competition grounds (Article 106(1) in conjunction with Article 101(3) TFEU). The regional principle is not connected with any advantages outweighing the associated harm to competition to the benefit of consumers.<sup>767</sup>

**1951.** The statutory regional principle does not sufficiently contribute to improving credit business services. To the contrary, it hinders the savings banks from developing innovative banking products in competition with each other, as it removes the incentive for them to acquire new customers with such products outside their traditional business territory. That impediment is not outweighed either by the fact that such incentives continue to exist to a limited extent due to the so-called connection principle. Those incentives derive exclusively from the fact that the savings banks can react to customer enquiries without violating the regional principle, which gives rise to certain passive competition among them. However, beside passive competition, active competition deserves protection as well.<sup>768</sup>

**1952.** No other justification follows from the arguments proposed by the DSGVO, in particular from the claimed better awareness of the local conditions and the ensuing possibility for the savings banks to effectively limit risks.<sup>769</sup> It cannot simply be presumed that such considerations (still) underlie the regional principle. Even under the present statutes, such informational advantages are no longer safeguarded by law, considering the possibility to merge across business territories and given the connection principle.

**1953.** The proposition that the aforementioned informational advantages sufficiently contribute to improving the supply of credit services, however, must also be rejected for de facto reasons. First, the informational advantages must be balanced against so-called concentration risks because the regional principle hinders the geographic diversification of the savings bank business. It cannot be determined so far that the informational advantages outbalance those risks. Second, it cannot be assumed that the savings banks would be exposed to higher risk during an expansion due to the fact that they have less information to appraise their potential customers’ credit risk. That argument may have some value in the credit business, but it is doubtful that it is relevant regarding the deposit business. In addition, one should expect that the savings banks would attempt, in case of an expansion, to acquire customers through better offers and not by lowering their credit standards. Risks would consequently result for the savings banks only from the fact that one cannot say in advance whether their offer would be competitive. Third, also the DSGVO’s argument must be rejected that the savings banks would encounter a disproportional number of less creditworthy customers outside their traditional territory. This would only be the case if customers could not be attracted by competitive offers. That would imply structural problems in competition, which the DSGVO does not admit to exist as it lays a stress on the existence of intense competition in the German banking market.

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<sup>766</sup> Article 4(3) TEU; Protocol No. 27 to the Treaties, OJ C 115, 9 May 2008, p. 309; from the case law: ECJ, Judgment of 10 January 1985, 229/83, Leclerc, [1985] E.C.R. 1, head note 1, paras. 14-15.

<sup>767</sup> See also European Commission, Guidelines on the application of Article 81(3) of the Treaty, OJ C 101, 27 April 2004, p. 97, para. 34.

<sup>768</sup> See European Commission, Guidelines on vertical restraints, OJ C 130, 19 May 2010, p. 1, para. 51, on the distinction between active and passive competition. In that regard, it is problematic that the savings banks accept deposits from neighbouring regions while seemingly even refraining from passive competition in the credit and loan business.

<sup>769</sup> DSGVO, Submission of 26 September 2013, p. 8; Submission of 30 January 2014, paras. 60-61 (as to this, see also para. 575 below).

**1954.** Yet, even if one were to subscribe to the argument that the regional principle is connected with informational advantages which improve on the whole the supply with credit services, this would not necessarily imply that those advantages are passed on to the consumers and that the associated restrictions are indispensable to attain this objective. In that regard, the DSGVO points to the broadened protection of creditors by dint of the group's liability association. The existing institutional guarantee system fully protecting the customers and the creditors could not be maintained, according to it, if the savings banks had to expect that individual members accumulate risk with an atypical profile by operating on unknown regional markets. The example of the cooperative banks, however, shows that a well-functioning institutional security can be established without a statutory regional principle.<sup>770</sup>

**1955.** Disregarding potential informational advantages it is not possible to identify competitive efficiencies that are associated with the statutory regional principle. That holds in particular with regard to the supply with credit services across the country.

**1956.** The DSGVO cautions that the supply of all parts of the population and of the regional economy with credit services could not be guaranteed anymore if the regional principle were removed. Without the regional principle, supply would not go to the local population and the local economy, but to those customers inside and outside the country that promise the highest returns. A permanent capital outflow from poor regions into rich regions would be the consequence. The abolition of the regional principle would thus further the desolation of those regions that are already now economically underdeveloped.<sup>771</sup>

**1957.** These arguments are astonishing. They are so the more accepting the concept of the savings acts and assumes a fundamental function of the statutory general-interest mandate for the savings banks' business model. The abolition of the statutory regional principle would not change said mandate to operate services of general interest, nor would it change the controlling municipal entities' obligation to ensure the fulfilment of the public mandate, the more if individual savings banks lose sight of this mandate. It seems rather problematic that the DSGVO apparently itself does not assume that the public mandate, on its own, is sufficient to bind the savings banks to a long-term and regionally oriented business strategy, and that it is instead necessary to have a statutory provision that is an express obstacle to a business expansion by the savings banks. This assumption reinforces the Monopolies Commission's impression that a sufficiently clear general-interest mandate has not been discernible any more already for quite a while.

**1958.** The savings banks' business model derived from their mandate to operate services of general interest also appears to be sustainable. It is beyond comprehension why the savings banks would abandon their principally locally oriented business strategy – which is successful according to the DSGVO – if they were required to cope with competition absent the distortion through the regional principle. The does not appear plausible taking into consideration that the cooperative banks are not subject to the statutory regional principle and nonetheless – and equally successful – adhere to a locally oriented business. Finally, the danger of further desolation of economically underdeveloped areas appears to be remote inasmuch as the savings banks would continue to be bound to the entity controlling them, and could not shift their business territory from economically feeble into economically strong regions. The only option for the individual savings bank would be to expand from the controlling entity's territory.

**1959.** The DSGVO's allusion to the private banks' withdrawal from the rural areas and the quoted foreign examples lack any substance.<sup>772</sup> The situation is in no case comparable with the savings

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<sup>770</sup> See FCO, Activity Report 1985/86, BT-Ds. 11/554, p. 95.

<sup>771</sup> DSGVO, Submission of 30 January 2014, paras. 54-57.

<sup>772</sup> DSGVO, Submission of 30 January 2014, paras. 41-42, 72 ff.; Submission of 26 September 2013, pp. 8-9, 9-10.

banks' situation. Whereas the savings banks cannot move their business away from the controlling entity's territory, the German private banks are not bound to a municipal entity. Their withdrawal from the rural areas is due, as the DSGVO points out itself, to the lack of attractiveness of those areas, i.e., to a strategic business decision. The same holds for the fact that foreign banks do not expand into the German rural areas.<sup>773</sup>

**1960.** Moreover, as far as can be seen, there does not appear to be any statutory link to a municipal entity exclusively responsible for its territory and using its undertakings to fulfil a binding general-interest mandate in those other Member States where the supply with credit services may have developed unfavourably. This is neglected by the DSGVO when it refers to the developments in Spain and the United Kingdom.

**1961.** Even aside from that, the example of the Spanish cajas is not convincing. The DSGVO sees a link between the collapse of the Spanish real property market during the financial crisis and the abolition of the regional principle for those banks. It notes itself, however, that the regional principle was abolished in Spain already in 1988. The problems of the cajas appear less linked to the abolition of the regional principle and more to their incapability to develop a competitive business strategy. The cajas were not forced to expand either following the abolition of the regional principle. They however did it, neglecting professional management, and pursued a business strategy where they did not hold sufficient capital for hazardous business, and where the risk management structures failed.<sup>774</sup>

**1962.** The situation in the United Kingdom is even less telling. It may be true that the market suffers from a virtual lack of effective competition and the absence of bank branches in many municipalities. This may also explain a certain interest that British political parties have developed in the German savings bank system. The British financial market is, however, traditionally oriented substantially towards London. To the extent that this gives rise to demand for locally oriented banks in rural areas, that demand could be satisfied by banks with an appropriate business model. A compulsory limitation of the business territory in accordance with the regional principle in the savings bank acts can nevertheless not be justified on that basis.

**1963.** In the Monopolies Commission's perspective, the statutory regional principle – being a statutory restraint exclusively on the savings banks – could be justified on competition grounds only if it were connected with economic benefits that can only be achieved through the regionally segmented associated structure of the savings bank group. In that regard, it is not sufficient that the regional principle (potentially) secures the fulfilment of the savings banks' mandate to operate services of general interest or business model, since a general-interest mandate is also imposed on other municipal undertakings, and a regionally oriented business model is also pursued by other banks, in particular the VR banks in the cooperative group. Thus, it remains open why a special statutory regional principle is indispensable regarding the savings banks while such a principle applies neither to other municipal undertakings nor to the cooperative banks.

#### ***4.4.4 No justification through the primacy of compulsory constitutional rules***

**1964.** The statutory regional principle cannot be accepted either because it is an outflow of the guarantee of local autonomy and self-administration, thus pertaining to the core values of the German

<sup>773</sup> See DSGVO, Submission of 30 January 2014, paras. 39-40.

<sup>774</sup> A particularly problematic aspect was that the management of many institutions was lacking the necessary banking expertise as most of its members were politicians, union representatives, and other persons using the cajas for their own interests. In addition, the cajas did not have the possibility during the crisis to collect additional capital as they could only have retained profits due to their legal form. Regarding the characteristics and the shortcomings of this business model, see broadly High-level Expert Group on reforming the structure of the EU banking sector (chair: Erkki Liikanen), Final Report, 2. October 2012, pp. 65-66.

constitutional order and thus being exempt from the scope of application of the European competition rules.<sup>775</sup>

**1965.** The Monopolies Commission does not see a need here to take a position regarding the question to what extent the guarantee of local autonomy itself and the related aspects of the democracy principle may be part of those core values. This holds at least in so far as the guarantee applies to the municipalities as the entities controlling the savings banks. The present report does not concern the guarantees established by the constitution and the municipal codes for the benefit of the municipalities, but only the additional restraint which the savings bank acts put on the savings banks – in contrast to other municipal undertakings.

**1966.** Regarding the savings bank system, however, the starting point is – contrary to what the DSGVO appears to claim – that the legislatures in the *Bundesländer* have a certain freedom to design their laws within the constitutional order. That freedom may be restricted in so far as the constitutional rules on local public business activities have to be respected, also where municipalities make use of legally independent municipal undertakings. This, though, can be relevant concerning the municipal undertakings as such only where the relevant rules shape the guaranteed local autonomy for the municipalities – as the beneficiaries of the guarantee. That being said, the jurisprudence has not extracted any particular principles from the constitutional rules, to the extent that the courts have ever looked into these constitutional questions, where those principles went beyond the guarantee of local autonomy for the municipalities and concerned the savings banks as such.<sup>776</sup> The statutory regional principle is a principle that relates to the savings banks and not to the municipalities, and that puts an additional restraint on the savings banks beyond the provisions of the municipal code. Such a provision cannot be expected to pertain to the constitutional core values from the outset.

**1967.** In addition, the savings have a double role as they are part of the system of (local) self-administration, and at the same time act as undertakings on the market. Against that background, the regional principle may be a part of the local self-administration of municipalities from the viewpoint of administrative law.<sup>777</sup> That does not exclude, however, that it is additionally subject to an independent assessment as a restraint on commercial activities under the competition rules. This is not least reflected in the Constitutional Court's position, which views the savings banks as institutions that offer services of general public interest, but at the same time accepts that the savings banks aim for profits and profit maximisation and, in that respect, have aligned their interests to those of the private banking sector.<sup>778</sup>

**1968.** Apart from that, the regional principle has been perforated through a number of statutory rules. The savings bank acts allow the savings banks to merge across territories and to establish branches. Furthermore, the connection principle has been developed over time. It is undisputed that these perforations allow the savings banks activities outside the territory of the entity which (traditionally)

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<sup>775</sup> Contrary to DSGVO, Submission of 30 January 2014, paras. 1, 10, 17, 28 and (more cautiously) para. 19; divergent para. 21, according to which it can be left open whether the guarantee of local autonomy belongs to the unalterable core values of the Constitution.

<sup>776</sup> See BayVerfGH, Decision of 23 September 1985, Vf. 8-VII-82, VerfGHE BY 38, 118 = [1986] DVBl 39, para. 80 (citation: Juris), where it is expressly stated that the constitution does not include any more concrete rules (precisely) on the organisation of savings banks; further VerfG Brandenburg, Judgment of 19 May 1994, 9/93, paras. 40 ff. (citation: Juris). The administrative courts' case law does not provide evidence either that the savings banks are subject to farther restrictions than the municipalities themselves or other municipal undertakings on constitutional grounds; see HessVGH, Judgment of 23 March 1966, OS II 6/63; OVG Lüneburg, Judgment of 21 November 1986, 2 OVG A 83/85; OVG NRW, Judgment of 20 October 1965, III A 630/64; equally BFH, Judgment of 25 July 1973, I R 185/71; all as quoted in DSGVO, Submission of 30 January 2014.

<sup>777</sup> See Sächs. OVG, Judgment of 8 November 2011, 4 A 637/10, para. 39 (citation: Juris).

<sup>778</sup> BVerfG, Decision of 14 April 1987, 1 BvR 775/84, BVerfGE 75, 192 = [1987] DVBl, 590, paras. 22-23 (citation: Juris).

has been controlling them.<sup>779</sup> Any substantial limitations usually do not emanate from the savings bank acts, but from the legitimate interests of the affected municipalities, whose protection is guaranteed through the constitution and by the municipal codes.

**1969.** For this reason, it can be assumed that the constitutionally protected mandate of the local community to operate services of general interest and the extraterritorial and profit-driven activities of the savings banks can be reconciled without entering into conflict with the core principles of the constitution. There is even less basis for the assumption that the constitution imposes a strict and exclusive local business territory on the savings banks.<sup>780</sup> The competent constitutional courts in the *Länder* have also so far rejected the idea of relating the regional principle to the core values of the constitutional order, or have left this question at least open.<sup>781</sup>

#### ***4.4.5 No justification through the general interest (Daseinsvorsorge)***

**1970.** The statutory regional principle is not justified through the general interest either. This does not change because such interests can be significant from a competition law perspective (Art. 106 Abs. 2, 14 TFEU). For example, undertakings may be exempted from the competition rules if they are entrusted with the operation of services of general economic interest. It is already questionable, though, whether the savings banks operate such services because general banking services (e.g., wire transfers, account management) cannot be regarded as such services absent particular circumstances.<sup>782</sup>

**1971.** In any event, no sufficiently compelling relation appears to exist between the relevant tasks of the savings banks and the market sharing associated with the regional principle. The competition rules would only disapply if their application would obstruct the savings banks in the performance of their particular task. This would only be the case if the fulfilment of the savings bank's public mandate would be jeopardised by undistorted regional competition.<sup>783</sup>

**1972.** No indications exist that this might be the case. No savings bank would be compelled to expand in a way jeopardising the fulfilment of its public service obligations. Further, according to the DSGVO, the savings banks must already now hold their ground against intense competition and still fulfil their public service obligations. To the contrary, it must be expected that the enforcement of the competition rules would increase the pressure to remove inefficient structures to the extent that such structures are protected by the regional principle. This would be to the benefit of the savings banks' customers.

**1973.** The statutory regional principle is not justified either due to the fact that this principle is related to the unlimited competence of the municipalities to operate services of public interest on the municipal territory.<sup>784</sup> This must be rejected because the regional principle, as is pointed out above – is an additional restraint placed on the savings banks. That restraint – as likewise stated above – also does not affect the municipalities as the public entities controlling the savings banks, but is placed on the savings banks themselves. Under EU law, it is necessary to distinguish between both addressees of the law.

<sup>779</sup> See DSGVO itself, Submission of 30 January 2014, para. 16. In this context, however, it remains unclear why the “expansion clauses” in the savings bank acts should be permissible under the Constitution whereas the obligations imposed by European competition law would be incompatible with the Constitution.

<sup>780</sup> Contrary, seemingly, to DSGVO, Submission of 30 January 2014, paras. 11-15, 18-20, 28 and the following paras. 29-30 (“Ausdruck der Ortsgebundenheit aller kommunalen Tätigkeiten”).

<sup>781</sup> BayVerfGH, Decision of 23 September 1985, Vf. 8-VII-82, VerfGHE BY 38, 118 = [1986] DVBl 39, para. 80; VerfG Brandenburg, Judgment of 19 May 1994, 9/93, para. 40 (each citation: Juris).

<sup>782</sup> ECJ, Judgment of 14 July 1981, 172/80, Züchner/Bayerische Vereinsbank, [1981] E.C.R. 2021, paras. 7-8.

<sup>783</sup> ECJ, Judgment of 23 October 1997, C-157/94, Commission v. Netherlands, [1997] E.C.R. I-5699, para. 43.

<sup>784</sup> Contrary to savings bank doctrine, see, e.g., Henneke, Kommunale Sparkassen – Verfassung und Organisation, 1st Ed. 2010, pp. 70, 162; Vogel, [2001] ZBB 103 (108); Schmidt, [1984] ZfGK No. 8, 342.

**1974.** The European Treaties besides do not call into question the operation of services of general interest (Article 4(2) EUV). That said, they protect such operation only within the framework established by the Treaties. The same holds where the municipalities engage in economic activities through municipal undertakings to that end.<sup>785</sup> In that regard, regularly no special treatment of entrepreneurial activities to operate services in the general interest is possible beyond Article 106(2) TFEU.

**1975.** The municipal competence to operate services of general interest cannot be farther reaching under the European Treaties than under national law (Article 28 of the Basic Law). In that respect, the statutory regional principle is traditionally justified through the necessity to guarantee the municipalities – given their unlimited competence – to regulate all local affairs on their own responsibility, within the limits prescribed by the laws. The mere competence of the municipalities regarding all local affairs, however, only encompasses the right to take up all tasks, but not a legal monopoly to regulate the municipalities' commercial activities, and even less an obligation to channel these operations through municipal undertakings.<sup>786</sup> Therefore, no municipality has the right to exclusively operate a savings bank (= legal monopoly) on its territory.<sup>787</sup> That supposition would be contrary to the economic neutrality of the Basic Law.

**1976.** An obligation to use the municipalities' own undertakings for meeting tasks of general interest cannot be derived from the municipal codes either although they provide more detailed rules on the unlimited competence of the municipalities. On that basis, each municipality must sufficiently heed the opposing interests of neighbouring municipalities and individuals during its commercial activities.<sup>788</sup> This, however, does not exclude competition between municipal undertakings. There is indeed active competition between municipal undertakings (e.g., fair management companies, municipal utilities in electricity supply and waste disposal). The municipalities are likewise free to establish their own savings banks, or to do without them. They can alternatively use savings banks established in other municipalities or private or cooperative banks if that is sufficient to ensure the supply of local credit services.

**1977.** The savings banks are not limited in their business activities because of their local general-interest mandate either. In the traditional view, their public character and the local attachment of the savings banks automatically limit their activities locally. It is, supposedly, the task of the savings banks to bind the locally collected deposits in the region and to reallocate them for commercial investments.

**1978.** That argument has already been rebutted, though, because a restriction of competition for the purpose of operating services in the local public interest can only be permitted to the extent that it is in accordance with Articles 101(3), 106(2) TFEU. In the present context, however, a justification of the regional principle under the competition rules must be discarded because the function of the savings banks to bind capital within the municipality follows from their general-interest mandate and not from the regional principle in the savings bank acts.<sup>789</sup> Likewise, as said above, there is no indication that

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<sup>785</sup> Declaration No. 17 to the Treaties, OJ C 115, 9 May 2008, p. 1 (344). Therefore DSGVO, Submission of 30 January 2014, para. 22, is not convincing.

<sup>786</sup> Cf. BVerfG, Decision of 23 November 1988, 2 BvR 1619 and 1628/83, BVerfGE 79, 127 = [1989] DVBl 300, Rastede, paras. 41 ff. (esp. paras. 48-50, 56); VerfGH Rhl.-Pf., Judgment of 28 March 2000, VGH N 12/98, para. 26; and, from a competition law perspective, BGH, Decision (reference to ECJ) of 11 March 1997, KZR 2/96, [1997] WRP 779, para. 31 (each citation: Juris).

<sup>787</sup> An exclusive right would flow from the regional principle as legally protected exclusivity to the advantage of one savings bank would be the correlate to the constitutional – according to the DSGVO – restraint on competition to the disadvantage of the other savings bank.

<sup>788</sup> See, e.g., § 107(3) GemO NW.

<sup>789</sup> See above, paras. 541 ff.

the enforcement of the competition rules with respect to the regional principle would hinder the savings banks to meet their obligation to ensure the supply with local services.

**1979.** Moreover, the guarantee of local autonomy only applies with respect to the municipalities and the municipal undertakings, but it does not empower the legislator of the savings bank acts. The savings bank acts are rooted in the competence of the *Länder* only to legislate whenever the Basic Law does not assign the specific competence to the federal institutions.

**1980.** The geographically defined competence of the municipalities to regulate all local affairs does not imply either that the savings banks act without a legal basis whenever they enter into competition beyond the local territory of the municipality (*ultra vires*). That argument cannot be derived, in particular, from the fact that the municipalities are the controlling entities responsible for the savings banks.

**1981.** On the one hand, the unlimited competence to regulate all local affairs does not hinder the municipalities from operating services that are related to the local territory and at the same time go beyond.<sup>790</sup> On the other hand, it must again be taken into account that the savings banks have a double role in that they are part of the municipal administration and at the same operate as an economic entity. It is, however, a fundamental principle of the market economy that participating undertakings, regardless of the control exercised by any controlling entity, are in competition with each other.

**1982.** That does not exclude that the controlling entities use their control rights to ensure that the controlled undertakings meet certain obligations of the controlling entity. The controlling stake may also justify legal provisions regarding those obligations. That does not necessarily imply, though, that the controlling stake also justifies restraints on the economic conduct which allows the undertakings to generate the revenues to meet the aforementioned obligations.

**1983.** Furthermore, the guarantee of the local autonomy under Article 28(2) of the Basic Law only exists “within the limits prescribed by the laws”. The same holds for the corresponding constitutional provisions in the *Länder*. The relevant laws include the provisions of German and European competition law. The legislatures in the *Länder* contravene the – binding<sup>791</sup> – objective of undistorted competition and acts beyond its competences if they enact legal provisions that are not permissible under EU law.

**1984.** Lastly, EU law takes primacy in its application, even if the position – which is here rejected from the outset – were true that the constitutional guarantee of municipal local autonomy and the European competition rules are in conflict with each other.<sup>792</sup>

#### ***4.4.6 No other justification on legal grounds***

**1985.** The regional principle in the savings bank acts cannot be justified based on other considerations, in particular not on the basis of the protection of the system of property ownership in Member States (Article 345 TFEU). In that regard, it must be made clear that the question in the present context is not whether the savings banks should be privatised.

**1986.** The DSGVO defends the regional principle based on the consideration that the protection of the system of property ownership relates to the “whether, if at all” of an economic activity of the State whereas Article 106 TFEU concerns the economic activity as such and, hence, the “how” of the activity. The legislatures in the *Länder* are alleged to have a competence to decide to what extent they

<sup>790</sup> VerfGH Sachsen, Judgment of 23 November 2000, Vf 62-II-99, para. 155 (citation: Juris).

<sup>791</sup> Article 4(3) TEU; Protocol No. 27 to the Treaties, OJ C 115, 9 May 2008, p. 309.

<sup>792</sup> ECJ, Judgment of 15 July 1964, 6/64, Costa/ENEL, [1964] E.C.R. 1251.

want to allow municipal undertakings to engage in economic activities.<sup>793</sup> The regional principle is said to be an admissible provision about the organisation of the municipal economic and financial system.

**1987.** This position could be defended under the condition that the regional principle is a fundamental municipal principle and thus pertains to the core values of the constitutional order, or that it is competitively neutral. Since both conditions are not met, however, it is not convincing for several reasons. First, the DSGVO itself assumes that the statutory regional principle can be a measure within the meaning of Article 106(1) TFEU, which relates to competitive conduct.<sup>794</sup> To the extent that the competition rules apply, they do not distinguish between undertakings controlled by the State and privately owned undertakings.<sup>795</sup> Thus, it is unclear why the regional principle, as an element of the system of property ownership in Member States could still be excluded from the competition rules. Second, it is not true that Member States and their constituent parts are competent on the basis of Article 345 TFEU alone to decide to what extent they submit their economic activities to the competition rules.<sup>796</sup> The aforementioned provision, thus, is no basis for the alleged competence to decide of the legislative institutions in the *Länder*. Third, it is not acceptable, as is apparently done here, to derive a distinction between a “whether” and a “how” of the economic activities from the principles on economic activities from German municipal law, and to apply that distinction to the relationship between Article 345 and Article 106(1) TFEU. The scope of application of the European competition rules is generally defined by Articles 101 ff. TFEU alone. It is therefore irrelevant that the regional principle could also be interpreted as a provision related to the organisation of the savings banks.

**1988.** Other legal principles accepted in German law (the democracy principle, the rule of law) are likewise no basis for justifying the regional principle. These provisions, too, would only be relevant in the present context if they were implicated in their function as the core values of the constitutional order, which is not the case. When legal writers refer to these principles, they also attribute to the regional principle the function of ensuring the control of the provision of credit services by the democratic representatives in the municipalities. However, that control is possible through the duty to report of the savings bank directors and not by way of a review of individual business transactions on the spot. In addition, the savings banks already provide services that are not bound to a certain territory and cannot be reviewed on the spot.

**1989.** The regional principle cannot be justified based on stability considerations either. It may be true that the decentralised structure of the German financial system has been a stabilising factor during the last financial crisis.<sup>797</sup> That being said, safeguarding the stability of the financial system is a task that

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<sup>793</sup> DSGVO, Submission of 26 September 2013, pp. 4 and 6; Submission of 30 January 2014, paras. 25-26.

<sup>794</sup> DSGVO, Submission of 26 September 2013, p. 3. The DSGVO here admits that a statute is a measure within the meaning of Article 106(1) TFEU, but it claims that this measure has not been enacted “in the case of” the savings banks.

<sup>795</sup> This is also how the Communication of 19 January 2001, OJ C 17 of 19 January 2001, as quoted by the DSGVO must be understood; as to the succeeding guidance, see European Commission, Communication on the application of the European Union State aid rules to compensation granted for the provision of services of general economic interest, OJ C 8, 11 January 2012, p. 4, fn. 1. Further, see ECJ, Judgment of 18 June 1998, C-35/96, *Commission v. Italy*, [1998] E.C.R. I-3851, head note 8, paras. 36, 40 (regarding Article 101 TFEU); ECJ, Judgment of 10 January 2006, C-222/04, *Cassa di Risparmio di Firenze*, [2006] E.C.R. I-289, paras. 8, 122-123 (regarding Article 107 TFEU).

<sup>796</sup> GC, Judgment of 13 June 2000, T-204/97 and T-270/97, EPAC, 2000 E.C.R. II-2267, head note 9 and para. 122; Judgment of 6 March 2003, T-228/99 and T-233/99, WestLB, [2003] E.C.R. II-435, paras. 192-196. Declaration No. 37 to the Treaty of Amsterdam, OJ C 340, 10 November 1997, p. 1 (138), as quoted by the DSGVO, Submission of 30 January 2014, para. 26, does not alter the assessment, the more so as this Declaration was not taken over into the Treaty of Lisbon.

<sup>797</sup> Council of Economic Experts, *Das deutsche Finanzsystem. Effizienz steigern – Stabilität erhöhen*, Expertise of 17 June 2008, para. 240; similarly DSGVO, Submission of 30 January 2014, para. 62.

the federal Legislature is entrusted with, not the legislatures in the *Länder*. The legislatures in the *Länder* are only called upon to regulate the savings bank system observing the higher-ranking legislation. That higher-ranking legislation encompasses the European competition rules. Again, a stabilising effect of the savings banks' locally oriented economic activities is moreover due to their business model, which is oriented towards a locally limited mandate to provide services of general interest, and not to the territorial restraint associated with the statutory regional principle.<sup>798</sup>

**1990.** The DSGVO apparently also takes the view that the statutory regional principle is necessary to safeguard the continued existence of the three-pillar system.<sup>799</sup> That assumption, however, is devoid of any basis. The three-pillar system has its basis in that the savings banks and the cooperative banks cannot easily be acquired by banks from the other pillars. That, however, is due to the legal form of the banks and not to the regional principle in the savings bank acts.

**1991.** The statutory regional principle is finally obsolete from a legal perspective. There may have been a justification for the relevant provisions at the time when the savings banks were profiting from sovereign guarantees during the fulfilment of their general-service obligations (*Anstaltslast- und Gewährträgerhaftung*), and when it had to be ensured that they exercised their business activities while profiting from those guarantees that served the Community interest in the territory of the controlling entity. The relevant guarantees have been abolished, though. Consequently, the reasons for the competition restriction associated with the regional principle are no longer valid.

**1992.** Finally, no legitimate interest considerations can be used to defend the statutory regional principle. It would be paradoxical from the outset if the savings banks claim a legitimate interest through the DSGVO to maintain a rule that restricts their freedom. If anything, such an argument may understandably be used to defend the existing market structure. However, the interest of a controlling local entity to protect its savings bank from competition is not legitimate. The same holds for the savings banks' confidence in that the regional market sharing scheme continues to exist as an "established structure". For a measure infringing Article 101 TFEU is inapplicable by law.<sup>800</sup> Consequently, there is no room for building up legitimate expectations.

#### ***4.4.7 The principle of loyal cooperation (Article 101(1)(c) TFEU in conjunction with Article 4(3) TEU)***

**1993.** It can be left open whether the prohibition of Article 101(1)(c) TFEU in conjunction with Article 4(3) TEU applies as well regarding the statutory regional principle. That suggests itself as the Federal Court of Justice has confirmed the violation of EU law by the lottery-law regionality principle for reasons that also militate against the regional principle in the savings bank acts. Moreover, it appears very doubtful that the two statutory principles have to be treated differently because a market sharing agreement preceded the regionality principle in lottery law.

**1994.** According to European case law, a violation of the principle of loyal cooperation depends in the competition context in particular on whether the respective Member State imposes a compulsory requirement under the law or whether it reserves or delegates the responsibility to the market participants.<sup>801</sup> Such a violation can be ruled out from the outset where the Member State imposes an exclusive provision that it could withdraw at any time. Under such circumstances, no room continues to exist for independent market behaviour of the market participants.<sup>802</sup> The situation is different

<sup>798</sup> Different DSGVO, Submission of 30 January 2014, paras. 60-61.

<sup>799</sup> The DSGVO, in its Submission of 30 January 2014, paras. 64-65, notes that the three-pillar system is advantageous and ensures intense competition on the German banking market.

<sup>800</sup> See FCO, Decision of 23 August 2006, B10-148/05, DLTB, para. 671.

<sup>801</sup> See, e.g., ECJ, Judgment of 18 June 1998, C-35/96, Commission v. Italy, [1998] E.C.R. I-3851, paras. 39-44; Judgment of 21 September 1988, 267/86, Van Eycke v. ASPA, [1988] E.C.R. 4769, paras. 16, 19.

<sup>802</sup> ECJ, Judgment of 21 September 1988, 267/86, Van Eycke v. ASPA, [1988] E.C.R. 4769, para. 19.

where the Member State does not impose a wholly exclusive provision, reserving room for interpretation and, thereby, room for independent market behaviour. Such circumstances are present, in particular, where a Member State requires or favours the adoption of cartel agreements, decisions or concerted practices or reinforces their effects.<sup>803</sup> In such case, there is room for applying the competition rules.

**1995.** Admittedly – unlike what is the case under Article 106(1) TFEU – German legal doctrine discusses whether a violation of the principle of local cooperation presupposes preceding anticompetitive conduct. However, European jurisprudence is not entirely clear on such an accessory element. Its acceptance would also have as its result that a contravention to Article 106(1) TFEU would not necessarily violate the principle of local cooperation because a contravention of Article 106(1) TFEU does not require preceding anticompetitive conduct. There would not be room for a violation of that principle either where a Member State – as is at present the case – adopts a provision contravening such a provision, which the affected undertakings can use to coordinate their behaviour. That does not seem to be convincing.

**1996.** That being said, that question does not have to be answered in the present context as the statutory regional principle clearly violates Article 106(1) TFEU. Thus, the principle of loyal cooperation is immaterial in this context.

#### **4.4.8 Intermediate result**

**1997.** The Monopolies Commission recommends the legislatures in the *Länder* to adapt the regional principle in cooperation with the competition authorities to the requirements of EU law. It underlines that the application of the statutory regional principle by the savings banks is subject to cartel enforcement as well.<sup>804</sup> The competition authorities are entitled to determine that the imposition of the regional principle by the savings bank acts violates EU law and that the statutes are consequently inapplicable.<sup>805</sup> In addition, they are entitled to determine that the savings banks themselves act in contravention to the competition rules when they apply the regional principle. This is because the savings banks do not lose their entrepreneurial freedom entirely through the adherence to the savings bank acts.<sup>806</sup>

#### **4.5 Need to act in various areas due to State aid risks**

**1998.** The Monopolies Commission is concerned that State aid may distort competition within the German banking system in a way that may prejudice the system. That holds, in particular, for the measures that were adopted during the financial crisis to stabilise the financial system.<sup>807</sup> In addition, it cannot be ruled out that the public-sector banks, despite the meanwhile implemented Brussels Concordance, continue to benefit from competitive advantages that are difficult to justify in any way. The Monopolies' Commission here sets out its concerns regarding the Member institutions of the savings bank group on the one hand and the public development banks on the other hand.

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<sup>803</sup> ECJ, Judgment of 18 June 1998, C-35/96, *Commission v. Italy*, [1998] E.C.R. I-3851, paras. 52 ff.; Judgment of 21 September 1988, 267/86, *Van Eycke v. ASPA*, [1988] E.C.R. 4769, paras. 16, 18.

<sup>804</sup> BGH, Decision of 10 November 2008, KVR 54/07, *Lottoblock*, WuW/E DE-R 2408, para. 83.

<sup>805</sup> ECJ, Judgment of 9 September 2003, C-198/01, *CIF*, [2003] E.C.R. I-8055, paras. 50-51; BGH, Decision of 14 August 2008, KVR 54/07, *Lottoblock*, WuW/E DE-R 2408, para. 83.

<sup>806</sup> Cf. ECJ, Judgment of 11 November 1997, C-359/95 P and C-379/95 P, *Ladbroke Racing*, [1997] E.C.R. I-6265, para. 33.

<sup>807</sup> See Section 3.5.

### 4.5.1 Possible State aid to the benefit of the savings bank group

**1999.** The Monopolies Commission is doubtful that the long existing competition distortions following from State aid to the benefit of the savings bank group have been entirely removed, and it asks for speedy legal clarification at least in some areas.

#### 4.5.1.1 Removal of State liability guarantees (*Anstaltslast and Gewährträgerhaftung*)?

**2000.** There is reason to assume that the competitive advantage for the *Landesbanken* and the savings banks, which had been associated with State liability guarantees in the event of default and for maintenance, has been removed. It is necessary, though, that adherence to the Brussels Concordance continues to be monitored.

**2001.** In regard of the State liability guarantees, the Monopolies Commission had pointed out early on that a commitment regarding the obligations of the public banks must be in line with the so-called private investor test.<sup>808</sup> In the relevant European Commission State aid case, the savings bank group had attempted to defend the farther-reaching liability guarantees. However, the group had itself thwarted the decisive argument, from a State aid perspective, that the guarantees were practically irrelevant by later claiming that their abolition would threaten the existence of the savings banks and the *Landesbanken*. The Brussels Concordance subsequently reduced the State's liability for the public banks to a measure that was acceptable under State aid law. The transitional periods granted to the savings banks and the *Landesbanken* (2001–2005/2015) were acceptable based on considerations of protecting their legitimate interests.

**2002.** The end of the State liability guarantees following the Brussels Concordance caused substantial disruptions on the *Landesbank* level in the period 2001–2010, yet these institutions have meanwhile at least partially been able to develop sustainable business models. The *Landesbanken* used to enjoy particularly favourable ratings by the rating agencies, due to the State liability guarantees. The prospect of that benefit ending, however, caused them to make investment decisions that proved to threaten the entire financial system only shortly afterwards in the financial crisis, and the backlash of which forced the *Landesbanken* to overhaul their entire business model.

**2003.** The effects of the Brussels Concordance at the level of the savings banks were much more modest. It is claimed that the legal foundations for organising the savings banks as public institutions has, in principle, fallen away with the abolition of the State liability guarantees. The actual business of the savings banks has not been called into question, however, because the savings banks have been able to obtain an associated group rating from the most important rating agencies and because most savings banks are not even large enough to be active in business areas where they need a rating.

**2004.** The controlling entities' willingness to take on responsibility for their savings banks and the *Landesbanken* was originally a constituting factor for the self-image of the entire savings bank group, notwithstanding the fact that the guarantee in the event of default has only seldom and the liability for maintenance has never been called upon. For that reason, the representative body of the administrative districts (Deutscher Landkreistag) and the DSGV saw a need to expressly confirm in a Joint Declaration of 25 January 2004 that the controlling municipal entities:

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<sup>808</sup> Monopolies Commission, XIIIth Main Report 1998/1999, Competition Policy in Network Structures, Baden-Baden 2000, para. 127; see, critically, already previously the XIth Main Report 1994/1995, Competition Policy in Times of Change, Baden-Baden 1996, paras. 113-114.

“[would] continue to vouch for ‘their’ savings banks in crisis situations, [and to] support them depending on the individual and concrete circumstances, for example to bridge economic difficulties in a given situation.”<sup>809</sup>

**2005.** Such a declaration can itself be relevant under State aid law if it creates the impression with other market participants that the State is willing to assume concrete responsibility to an extent that exceeds the liability of a private capital investor.<sup>810</sup> That said, the increased refinancing cost of the group immediately following the Brussels Concordance (2001–2005) shows that the good ratings of the members of the associated group after 2005 must on the whole be traced back to the concept of association of the savings bank group. Even where the rating agencies have continued to consider an “implicit guarantee” to the benefit of the savings bank group in their ratings after 2005, it is unclear to what extent that was related to the solidarity declaration quoted above, beyond existing State control. State control as such, however, is not relevant from a State aid perspective (*argumentum ex Article 345 TFEU*).

**2006.** The Monopolies Commission assumes that the advantage associated with the liability in the event of default and the maintenance guarantee probably no longer exist. That being said, the willingness of the State to show special solidarity with the members of the savings bank group may still trigger political measures to the benefit of group members, which can be relevant under State aid law. The Monopolies Commission therefore sees a need for the relations between the controlling public entities and the associated group to be scrupulously monitored. Furthermore, the Monopolies Commission underlines that the risks regarding competition distortions, which are associated with such public control, make it absolutely necessary from a competition policy perspective to clearly define the general-interest mandate that the public banks are meant to pursue. Otherwise, the activities of the State in the financial sector cannot be justified.

#### 4.5.1.2 Continued State aid for the Landesbanken

**2007.** The Monopolies Commission views the continued measures to strengthen the *Landesbanken*’s capital base critical. It must be recalled that the *Landesbanken* are the group of institutions that have had to be saved or made more robust the most often since the outbreak of the financial crisis.

**2008.** These support measures were not completed during the period covered by this Report. While most *Landesbanken* have been able to re-pay a large part of the State aid they had received, additional support has been granted, in particular to HSH Nordbank. The European Commission has voiced concerns as to the compatibility of the measures with the provisions on State aid.<sup>811</sup> The Commission had voiced such concerns already during previous measures to the benefit of HSH Nordbank, even though these measures have been considered to be compatible with the common market in the end.<sup>812</sup> From hearings of the responsible committees at the level of the *Länder*, however, it has been reported that the controlling public entities only consider the continued existence of HSH Nordbank as being relevant, irrespective of the compatibility of the measures with the common market. Regarding the

<sup>809</sup> Deutscher Landkreistag and Deutscher Sparkassen- und Giroverband, Notwendigkeit der öffentlich-rechtlichen Struktur der kommunalen Sparkassen, joint declaration of 25 January 2004.

<sup>810</sup> ECJ, Judgment of 3 April 2014, C-559/12, *France v. Commission*, not yet officially reported, paras. 94 ff.; ECJ, Judgment of 8 December 2011, C-275/10, *Residex Capital IV*, [2011] E.C.R. I-13043, paras. 39 ff.; Judgment of 19 March 2013, C-399/10 P and C-401/10 P, *Bouygues*, not yet officially reported, paras. 107 ff., 128 ff. Further, see the still existing, scattered references to the controlling entity’s position as a liable entity (*Gewährträgerstellung*), e.g., in § 3 SpkVO MV.

<sup>811</sup> European Commission, Decision of 21 June 2013, SA.29338 (C 30/2013), Germany. Increase of the ceiling amount of a second-loss guarantee for HSH Nordbank AG, paras. 47 ff.

<sup>812</sup> European Commission, Decision of 22 October 2009, C 29/2009, Germany. HSH Nordbank, paras. 40, 42, 47-48, 50 ff.; further, see European Commission, Decision of 20 September 2011, C 29/2009, Germany. HSH Nordbank, paras. 167, 173-174, 177, 191 ff.

other *Landesbanken*, it is still unclear whether the State will abide by the commitments to withdraw, which it had made in some cases during the crisis.<sup>813</sup>

**2009.** The Monopolies Commission acknowledges that the measures to rescue the *Landesbanken* during the financial crisis may have been justified to reduce systemic risk. To the extent that the *Landesbanken* have a clearly defined public mandate and pursue a sustainable business model, there may also be some justification for maintaining these institutions in the long term. This includes maintaining the *Landesbanken* under public control, at least in so far as there is no obligation through the State aid proceedings to privatise them.

**2010.** That being said, it remains questionable whether it is necessary to still operate the relatively high number of six independent (and two dependent) *Landesbanken*. Apart from that, it should be noted that also justified State aid measures can be accompanied by substantial distortions of competition. If it were true that individual *Länder* consider the review of State aid only as a burdensome formality, such a stance would be unacceptable.

#### 4.5.1.3 Continued statutory advantages for the savings banks

**2011.** In the Monopolies Commission's view, indications exist that the savings banks continue to benefit from statutory advantages that are relevant under State aid law. This concern is not alleviated by the fact that the savings banks nowadays typically act not as the long arm of the State, but essentially the same way as private market participants.<sup>814</sup>

**2012.** The Monopolies Commission's concerns relate in particular to the rules on the use of surplus profits in the savings bank acts.<sup>815</sup> These rules provide that the savings banks' surplus profits from a given business year may only be distributed to the controlling entity or used for objectives in the general interest only to a certain extent and in pre-defined relation to the contingency funds. In that context, it is regularly in the administrative council's discretion whether the surplus not added to the contingency funds, i.e., the free surplus, is distributed to the controlling entity. The amount of free surplus varies depending on the law in the *Länder*. In any event, the law provides that at least part of the surplus, which does not have to be used for the absorption of losses and risk precautions, is reserved for the savings banks. That amount of the surplus does not have to be used for objectives in the general interest either.

**2013.** A relevant advantage within the meaning of Article 107(1) TFEU may consist of any benefit that is granted to the savings banks from State resources. In that regard, it suffices that the burdens on the savings banks are alleviated, which an undertaking usually has to bear. According to the Brussels Concordance, such benefits shall be excluded inasmuch as the "financial relations" between the savings banks and the controlling entities may "not differ from a normal economic relationship with an owner based on market economy principles, as is the case between a private shareholder and an undertaking in the legal form of a company with limited liability". Thus, it is necessary to compare the savings banks and undertakings organised as a corporation.

**2014.** It cannot be assumed that the statutory surplus rules form part of the organisation of savings banks and therefore are from the outset excluded from State aid review. The establishment of the

<sup>813</sup> See no author, Seehofer: Wollen BayernLB so bald wie möglich verkaufen, [www.merkur-online.de](http://www.merkur-online.de), 15 December 2009.

<sup>814</sup> See European Commission, Decision of 11 January 2008, N 836/2006, Mittelstandsfonds Schleswig-Holstein, paras. 110 ff. on the State aid assessment of the savings bank interest in a development fund.

<sup>815</sup> § 31 SpG BW, § 21 BaySpkO, § 27 BrdbgSpkG, § 23 BremSpkG, § 16 SpkG Hessen, § 27 SpkG MV, § 24 NSpG, § 20 SpkG RP, § 25 SSpG, § 27 SächsSpkG, § 27 SpkG-LSA, § 27 SpkG SH, § 21 ThürSpkG. Different, e.g., Article 12 BayLBG, §§ 24(4)(2), 25 SpkG NW. The savings bank act of Berlin does not contain any rules on surplus profits.

savings banks as public institutions is itself based on a sovereign decision. However, that does not mean that the savings banks in that regard only contain provisions of sovereign law. Rather, it is necessary to decide in the individual case whether the respective provision must be understood as an exercise of sovereign powers or as the shaping of the State's economic activities.<sup>816</sup> Provisions which concern the capital of a public undertakings or the interest on the used public funds should generally be assigned to the State's economic activities.<sup>817</sup>

**2015.** It is no obstacle to the required comparison that the surplus provisions in the savings bank acts must take account of the fact that the savings banks – unlike other undertakings – have to fulfil a general-interest mandate. Measures such as the relevant surplus rules can be viewed as neutral from the angle of State aid if they are provided for the compensation of the operation of services in the general economic interest.<sup>818</sup> It cannot be assumed, though, that the savings banks' business activities as a whole are services in the general economic interest.<sup>819</sup> To the extent that this is not the case, it can easily be taken into consideration during the necessary comparison that the entities controlling the savings banks can be entitled, as owners, or even obligated to use profits generated by the savings bank for services in the general interest.<sup>820</sup> The question here, however, precedes questions relating to the use of the profits, i.e., whether the non-distribution of surplus profits regardless of the rules of § 10 KWG includes an advantage in terms of State aid law for the savings banks.

**2016.** In the view of the Monopolies Commission, it indeed cannot be ruled out that the savings banks benefit from an advantage from State resources that is relevant under State aid law. It is the European Commission's opinion, which has been repeatedly confirmed in European jurisprudence, that a private capital investor that offers its capital to a bank as equity will generally ask for remuneration for the entire capital transferred to the bank.<sup>821</sup> A corresponding concept also exists in German corporate law.<sup>822</sup> The provisions on the use of surplus profits in the savings bank acts, however, are structured in a way that the controlling entities are not able to retain the savings bank profits, which they would obtain as the owners of a regular corporation. That potential advantage for the savings banks comes ultimately from State resources. In that regard, it is decisive that the savings banks were originally created by the controlling entities taking recourse to public money. By the savings banks depositing their non-distributed capital with the *Landesbanken*, the latter potentially benefit indirectly from the relevant advantage beside the savings banks.

**2017.** An advantage emanating from the relevant provisions is probably not excluded by the fact that the savings banks depend on profit retention (the retention of earnings) as the controlling entities only participate in the surplus of their savings banks following the end of the State liability guarantees, but not in their losses. In a corporation, the right to have profits distributed likewise does not necessarily

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<sup>816</sup> GC, Judgment of 17 December 2008, T-196/04, *Ryanair*, [2008] E.C.R. II-3643, paras. 88-98; Further ECJ, Judgment of 5 June 2012, C-124/10 P, *EDF*, not yet officially reported, para. 80 (regarding the element "from State resources") following GC, Judgment of 15 December 2009, T-156/04, *EDF*, [2009] E.C.R. II-4503, paras. 223 ff.

<sup>817</sup> See also Article 3 Directive 2006/111/EC, OJ L 318, 17 November 2006, p. 17.

<sup>818</sup> Cf. ECJ, Judgment of 9 June 2011, C-71/09 P, C-73/09 P and C-76/09 P, *Venezia vuole vivere*, [2011] E.C.R. I-4727, paras. 92-95; further ECJ, Judgment of 5 June 2012, C-124/10 P, *EDF*, not yet officially reported, paras. 76-78.

<sup>819</sup> See para. 1970 above.

<sup>820</sup> Cf. also European Commission, Decision 2006/742/EC of 20 October 2004, OJ L 307, 7 November 2006, p. 159, paras. 141-142, confirmed by GC, Judgment of 3 March 2010, T-163/05, *Bundesverband deutscher Banken*, [2010] E.C.R. II-387, paras. 11, 61 ff.

<sup>821</sup> European Commission, Communication, Application of Articles 92 and 93 of the EEC Treaty to public authorities' holdings in company capital, Bulletin EC 9-1984, Section 3.3; GC, Judgment of 3 March 2010, T-163/05, *Bundesverband deutscher Banken*, [2010] E.C.R. II-387, para. 59.

<sup>822</sup> See, e.g., §§ 174, 288 AktG, § 29 GmbHG; and §§ 120-122, 167-169, 231-232 HGB, 721-722 BGB in partnership law.

accompany an additional payment liability to compensate for losses.<sup>823</sup> In addition, the savings banks can on principle take on additional capital through the deposits of silent partners, the sale of profit sharing rights or second-tier liabilities.<sup>824</sup> An advantage relevant under State aid law must be considered at least in so far as the savings banks are able by virtue of the rules on surplus profits to strengthen the basis of their capital to a larger degree than comparable credit institutions.

**2018.** It has also to be assumed that such a benefit can distort competition and have an effect on trade between Member States. According to a report from the audit court in the *Land Hesse* from 2012, for example, the savings banks generated surplus profits in 2009 in the amount of EUR 145.5 million, with approximately 86% (EUR 125.5 million) being allocated to their reserve funds. Nine of the 33 savings banks transferred only EUR 20.2 million to the municipal controlling entities for purposes of general interest.<sup>825</sup> It has been the result also of other inquiries that the savings banks have in a number of cases allocated more than 90% of their annual surplus to the contingency funds. Other banks, which must take the interests of their owners (shareholders) into consideration, are generally not in a position to strengthen their capital to such an extent. In a situation like the fading crisis, the solvency of banks is very important to the customers, and the strengthening of capital above the average may constitute an important competitive advantage for the savings banks. It must be assumed, for instance, that the savings banks can hand out loans to corporate customers at conditions that are not always risk adequate because they are satisfied with relatively small returns. That is not least problematic because the savings banks have probably frequently market power in the relevant market segment. The European Commission has so far signalled that a State aid advantage could only be accepted to benefit smaller savings banks with a regional scope of activities without further justification.

**2019.** It appears doubtful, however, whether and to what extent the distortions of competition mentioned above can be justified. The retention of very much capital contributes to the stability of the financial system. In addition, it may be assumed for the benefit of the savings banks that they allocate part of their earnings to services of general interest, thereby not generating any or at least not any large returns (e.g., when offering basic accounts to everyone, when funding cultural activities). The savings banks correspondingly achieve lower profits than their competitors. That being said, it is problematic that the statutory rules largely leave the surplus profits to the savings banks – beyond the necessary funds to serve the contingency funds – without the use being regulated and probably without the controlling entities having an overview of their use.<sup>826</sup> The assumption that a justification exists for the potential distortions of competition, associated with the surplus rules, therefore has no sustainable basis.

**2020.** Apart from the surplus rules, the Monopolies Commission takes a critical view on the sporadic exemptions from taxes and from legal fees for measures relating to legal changes under the savings bank acts and the laws on the *Landesbanken*.<sup>827</sup> In that respect, it is likewise questionable whether the

<sup>823</sup> § 26(1) GmbHG (“may”); see also § 182 (1) AktG (“may only” [“kann nur”]); unofficial translation).

<sup>824</sup> §§ 21 ff. SpkG Hesse, § 26 SpkG NW, § 21 SpkG RP. To the extent that legislature has abstained from such provisions in several *Länder*, this does not alter the State aid law assessment.

<sup>825</sup> Hessischer Rechnungshof, 23. Zusammenfassender Bericht (Kommunalbericht), Hess. LT-Ds. 18/5913, p. 238.

<sup>826</sup> Cf. Hessischer Rechnungshof, 23. Zusammenfassender Bericht (Kommunalbericht), Hess. LT-Ds. 18/5913, pp. 241 ff. These allocations to the contingency funds exceed the consumption rates that had been calculated for the capitalisation of the security funds pursuant to § 12 Einlagensicherungs- und Anlegerschutzgesetz in the context of the abolition of the State liability guarantees; cf. Witte/Rafiqpoor, [2003] WM 1885 (1888).

<sup>827</sup> See § 14 BerlSpkG, § 24 SpkG RP, § 15 Interstate Agreement on Bremer Landesbank Kreditanstalt Oldenburg – Girozentrale –, Article 17 Interstate Agreement on Norddeutsche Landesbank – Girozentrale –; further ECJ, Judgment of 19 September 2000, C-156/98, *Germany v. Commission*, [2000] E.C.R. I-6857; Judgment of 22 June 2006, C-182/03 and C-217/03, *Forum 187*, [2006] E.C.R. I-5479; Judgment of 22 November 2000, C-53/00, *Ferring*, [2001] E.C.R. I-9067, on the relevance of tax benefits under the State aid rules.

measures are only relevant from an organisation perspective, or whether they rather imply benefits relevant under State aid law.

**2021.** The Monopolies Commission recommends that the surplus provisions be aligned more with the State aid rules. This might make it necessary that the controlling entities obtain the right within the confines of what is defensible from a supervisory perspective to grant the controlling entities farther-reaching control of the surplus profits of the savings banks.<sup>828</sup> This, however, would also enable the controlling entities to fully meet their constitutional obligations to control the savings bank activities and to hinder distortions of competition. That said, in the general interest, the restriction should be retained that distributed surplus profits should only be used for the public good. The tax exemptions should be deleted without substitution for reasons of equal treatment.

#### **4.5.2 State aid to the benefit of the development banks**

**2022.** Furthermore, the Monopolies Commission sees State aid risks with regard to the development banks, in particular with regard to KfW.<sup>829</sup> These risks stem from the fact that the development banks regularly still benefit from public liability in case of default and the maintenance guarantee. The State liability guarantees represent an advantage in terms of State aid law in the form of an unlimited State guarantee.<sup>830</sup>

**2023.** This advantage can give rise to State aid concerns at any use of the State liability outside a development mandate that is exempted from competition law under Article 106(2)(1) TFEU. In regard of individual development banks, it cannot be excluded that the State liability guarantees have effects distorting competition, and that is in two respects:

- the development outside a development mandate exempted by Article 106(2) TFEU, and
- the public-relations work outside what is necessary for successfully meeting such a development mandate.

A distortion of competition by the relevant development banks is not hindered by the fact that the furtherance funded by the institutions itself has been notified and cleared under State aid law because in such proceeding no assessment takes place of a benefit granted to the respective institution.<sup>831</sup>

**2024.** In the case of KfW, the use of the liability guarantees would also give rise to concerns if the institution – as is occasionally called for by political representatives – would have to distribute surplus profits to the federal budget without using them itself for the fulfilment of its development mandate in any respect. The aforementioned propositions have not been pursued to date, though, and the Monopolies Commission consequently limits its present assessment to the issue of the business expansion.

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<sup>828</sup> Cf. European Commission, Communication on public undertakings in the manufacturing sector, OJ C 307, 13 November 1993, p. 3, and GC, Judgment of 6 March 2003, T-228/99 and T-233/99, WestLB, [2003] E.C.R. II-435, paras. 255 ff. on the calculation of profits viewed neutrally under State aid law.

<sup>829</sup> Cf. already Monopolies Commission, XVIIth Main Report 2006/2007, Less State, More Competition, Baden-Baden 2008, paras. 902 ff. as to State aid in cases of market failure. On the territorial restrictions for development banks (including the guarantee banks [*Bürgschaftsbanken*]), see moreover Section 4.2 (particularly, Section 4.2.3) and Section 4.4.4 above.

<sup>830</sup> See European Commission, Notice on the application of Articles 87 and 88 of the EC Treaty to State aid in the form of guarantees, OJ C 155, 20 June 2008, p. 10, particularly, Sections 2.3.2 and 3.1.

<sup>831</sup> Such assessments took place in relation to undertakings profiting from KfW development programmes, see, e.g., European Commission, Decision of 19 March 2010, N 401/2009, Germany - ERP Startfonds (Risk capital), paras. 5, 29; Decision of 20 September 2011, SA.32520, Germany – Risk Capital Scheme ‘High-Tech Gründerfonds II’, para. 65; Decision of 11 January 2008, N 836/2006, Mittelstandsfonds Schleswig-Holstein, paras. 25, 114.

**2025.** In several discussions with representatives from the German banking industry and written submissions, complaints have been made that indicate that banks and other undertakings could offer services in certain areas to a sufficient extent at market conditions, but that those services are in fact not being offered because the development banks subsidise, or foreclose the offers of other financing companies through their development activities. According to those statements, the development banks may postulate demand that is not fully covered by their mandate in the general interest because it does not exist in the way it is postulated, or because it does not require the given conditions of furtherance. The development banks consulted on the issue consider these complaints not to be justified. They claim they are active where market failure (or at least “market frailty”) can be established based on macroeconomic studies.

**2026.** Notwithstanding their allegations, though, the representatives of banking associations draw a picture that is individually nuanced. There is consensus that cases of market failure exist where it is not profitable for commercial banks and other market participants to develop their own products.

For example, it should be still the most probable in Germany with regard to the financing of newly established enterprises (start-ups) that the activities of the development banks are justified by a development mandate. The financing can apparently not be provided to a sufficient extent through banks and venture-capital corporations.

In contrast, the development banks stand at least to some extent in competition with other banks as regards housing development and the issuance of covered bonds.<sup>832</sup> In that regard, it can be questioned whether they provide services in the general interest, which require the use of refinancing advantages with State-aid relevance to the present extent. According to the associations, the commercial banks are able to cover demand at least in some market segments sufficiently with their own products, for example, as concerns the construction and purchase of housing for occupational purposes (association representative: “everybody finances housing”). Indications of dead-weight effects at the banks passing on the development loans likewise point to excess furtherance that currently exists in the area of housing financing.

Study loans at acceptable conditions for university students have given rise to the claim that banks have stopped the development of their own products after KfW took on the furtherance in that area. Thus, competition might have been foreclosed in this area without need.

Finally, a special role must be attributed to export financing, which is a service provided by KfW and in isolated cases by the development banks in the *Länder* (e.g., Bavarian LfA). KfW has transferred the development and market activities in this area to a subsidiary to meet concerns under State aid law. Accordingly, the activities of the institution are not limited to meeting a development mandate without distorting competition. The representatives of the associations criticise in that regard that the isolation of the export funding business is not sufficiently clearly visible to the market participants.

**2027.** Regarding the activities of the development banks in the *Länder*, though, evidence is sparse that points to the existence of activities where it is doubtful from the outset if they are covered by a general-interest mandate. This holds for the above-mentioned areas as well as other tasks that the institutions have to meet in the individual case. For example, NRW.Bank operates casinos, and it does so even outside the borders of the *Land* Northrhine-Westfalia. This, however, is a business that is not in the strategic focus of NRW.Bank, and the institution plans to end these activities outside the *Land* in the foreseeable future.

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<sup>832</sup> See also European Commission, Decision of 14 May 2009, COMP/M.5508, Soffin/Hypo Real Estate, paras. 28 ff.

**2028.** An additional potential problem results from the fact that individual development banks (especially KfW) increasingly align their advertising with marketing objectives, as can be deduced from the following circumstances:

- The advertising is primarily used to address the consumers in a targeted way as customers. The respective bank explains its actual development activities principally in the areas that are directly relevant for consumers, and limits itself to rather general statements in the other areas (e.g., development and export financing), without these statements providing additional information concerning the demand for individual development programmes and their volumes. The website includes references to the fact that the bank is, or should be active primarily through other institutions only on the pages concerning investor relations.
- In addition, similar to a commercial bank, KfW in particular tries to improve the profile of its brands with consumers by means of additional marketing measures. To that end, it uses marketing agencies and marketing consultants that are experienced specifically in the customer relations area. Using the slogan: “*Die neue KfW*” (“New KfW”), it has given itself a claim that identifies the institutions as a bank oriented “to the consumers’ needs”.<sup>833</sup>

These measures have as their result that not the development itself (typically through transfer institutions) is in the centre of perception, but the bank itself as a supplier. Thereby, in the view of other market participants, the boundaries between public-relations work directed at informing the public on development opportunities and marketing directed at expanding the business become increasingly blurred.

**2029.** The Monopolies Commission considers that the submitted complaints are serious from a competition policy perspective. That being said, it here dispenses with an express judgment as to whether the respective complaints may in its view be justified. Especially the determination of market failure, which could justify the activities of the development banks, is only possible on an individual basis and goes beyond the scope of this Report. Instead, the Monopolies Commission uses in the following the study loans offered by KfW as an example to show what limits have to be observed in its view in the development and the operation of development programmes.<sup>834</sup>

**2030.** It must be noted that the supply of study loans at conditions bearable for university students is not necessarily subject to a State aid assessment. A review under the State aid rules would not be justified in particular if KfW were entrusted in that regard with operating a service of general economic interest, and if the application of the competition rules would in law or in fact obstruct the performance of that task (Article 106(2)(1) TFEU).

**2031.** Study loans can clearly be regarded as the provision of services in the general interest. The objective pursued with the KfW’s study loans is to increase the number of university graduates and, in particular, to make university studies possible for students from families without the means. The KfW study loans are granted to students of the two sexes at publicly recognised universities if they are Germans or EU citizens, have not completed their 44<sup>th</sup> year and meet certain requirements concerning the duration and records of study. There is no right to the grant of a KfW study loan.

**2032.** Students from families without means, who are not able to afford university studies at market loan conditions, can use different financing means. However, these measures are not in competition with each other as they are provided outside the market from the outset.<sup>835</sup> For example, students in

<sup>833</sup> “Bank aus Verantwortung”; see: <http://www.bank-aus-verantwortung.de/wasVeraendertSich.html> (Link meanwhile deactivated).

<sup>834</sup> The study loans introduced 2006 are financing measures within the meaning of European Commission, Decision of 27 March 2002, E 10/2000, Germany. Anstaltslast und Gewährträgerhaftung, p. 11, No. 2.d, last dash.

<sup>835</sup> See also European Commission, Communication on the application of the European Union State aid rules to

need, who cannot bear market loan conditions, can take recourse to the Federal Education and Trainings Assistance Programme (Bafög) as an alternative financing measure. For students that studied in *Bundesländer* with tuition fees, so-called study contribution loans were introduced, which are offered by KfW and the development banks of the *Länder*, but whose future is uncertain after the abolition of tuition fees.

**2033.** It is, however, questionable whether the refinancing of KfW's study loan products requires State aid excepted from European competition law also to the extent that the study loans are granted to students who are not without means. Originally, an argument was for such an exception that KfW had developed its own study loan products after determining market failure regarding the funding of university studies. That market failure was due to the fact that an assessment of the default risk is particularly difficult in the case of study loans. In KfW's view, before its own activities, the commercial banks had not been able to offer study loans at conditions that were bearable for the students. However, it must be stressed that market failure is not the same as competition failure. Competition must also be protected if the market conditions do not leave much scope for competitive offers. In the case of study loans, competition with such products was nascent when KfW entered the market. Other suppliers had developed their own study loan products more or less at the same time as KfW, and have in some cases continued to do so even after KfW had entered the market.<sup>836</sup> These products, though, were often products of a limited scope for a particular university or a particular university subject. That said, the assumption that such products target only customer groups without large default risks cannot be confirmed, in particular regarding the products offered by savings banks. Aside from that, it cannot be ruled out that, from the outset, State insurance against the default risk would have been sufficient as a market intervention in order to guarantee the adequate provision of study loans through normal banks and savings banks<sup>837</sup> That type of insurance, according to KfW, could not have been provided by KfW, but through the federal State or the *Länder*. Consequently, indications exist that the refinancing of study loans was at least not fully outside the scope of competition law from the outset. Even if the opposite had been the case, the assessment might have to change because KfW meanwhile has better experience of the calculation of credit default risks, and the costs originally necessitating State-aid guaranteed refinancing probably have diminished considerably in the meantime.

**2034.** If the competition rules apply in this context, that does not imply at all that the offer of study loans or the possibility of refinancing them by use of the public liability guarantees is impermissible. However, KfW would be a dominant provider of study loans and therefore would have to take into account competition aspects much more than it does to date, not only because of the risk of State-aid induced competition distortions. This is sketched out in the following.

**2035.** To the extent that KfW benefits from a State aid advantage due to the State liability guarantees (para. 2022), the State liability guarantees to KfW's benefit can distort competition, both on the markets where KfW finances development measures (use of means) and on all markets where KfW is active for refinancing purposes (procurement of means). On the latter markets, a distortion of competition must be expected because investors assume – at least in extreme situations – that the State is more able to pay back its liabilities than private banks, meaning that they will grant particularly advantageous refinancing conditions to a development bank. On the markets on which KfW provides

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compensation granted for the provision of services of general economic interest, OJ C 8, 11 January 2012, p. 4, paras. 11 ff., indicating that probably already an entrepreneurial (economic) activity is missing.

<sup>836</sup> See, e.g., tiw, Sparkassen starten Studienkredit, *Der Tagesspiegel*, 7 September 2005; President Hoppenstedt (DSGV) and President Müller (BdB) in: Knipper, et al., “Es geht nicht um Krieg und Frieden”, Interview in: *Handelsblatt*, 16 May 2005; Götsch, Gerangel um Studienkredite, *FTD*, 5 June 2008. For a market overview as to the current product offers, see CHE, CHE-Studienkredit-Test 2013, AP No. 165 (June 2013).

<sup>837</sup> See also Scientific Advisory Council at the Federal Ministry of Finance, *Beitragspflichtiger Hochschulzugang*, Expertise of September 2010, pp. 20 ff.; sceptically regarding the issue of market failure, p. 22.

its development products, it can foreclose other potential suppliers and impede the development of the market through its activities; for example, by skimming off the demand for study loans to a large extent for its own benefit. Thus, according to market participants, a number of banks have already withdrawn from the development and distribution of own products because it is more economical to pass on KfW study loans through commission-based transactions (“liquidity protection”).

**2036.** This does not exclude that the State-aid based refinancing of KfW’s activities is justified. A justification does not simply follow from the Brussels Concordance (Accord II)<sup>838</sup> if a private capital investor had reserved a (renewed) decision on whether the liability guarantees to KfW’s benefit can also be used for the purpose of refinancing study loans.<sup>839</sup> That being said, such State aid can still be justified because study loans can only be provided to a sufficient amount – even assuming that others had experience in the expected credit default risks to the extent necessary for market activities – under the condition that KfW makes use of its refinancing advantages.

**2037.** Apart from these questions rooted in State aid law, KfW can be assumed to have a dominant position on the market for study loans, given the fact that it is by far the most important provider. Special responsibility for its market conduct comes along with this. Thus, it cannot be excluded, for instance, that other potential suppliers of study loans may be entitled to demand access to information or methods concerning the credit default risk if this information or these methods are essential for entering the market.<sup>840</sup> The question of whether KfW acts outside the scope of the competition rules may have to be decided differently in relation to the access to such information or such methods as well. Accord II has no bearing on this potential competitor right.

**2038.** In sum, the Monopolies Commission assumes that the competitors of KfW may, under the circumstances, themselves be able to create a better-functioning market for study loans, at least under the conditions that KfW has in the meantime identified the necessary information and methods to correctly ascertain the credit default risk when offering such products, and if the provision of such products is sustainable without taking recourse to the refinancing advantages resulting from the State liability guarantees. This does not exclude, however, that the State-aid supported activities of KfW continue to be justified, for instance, because other suppliers are not interested in creating competitive products in view of the low margins that can be expected. This appears likely in particular given the fact that the offer of study loans does not give rise to many complaints, as compared to other KfW products.

**2039.** In view of the other complaints voiced, however, it must be questioned whether supervision has been sufficient so far regarding the activities of KfW in competition. In any event, the Monopolies Commission welcomes the newly established option by law to transfer supervision by regulation from the Federal Ministry of Finance to BaFin, and it also welcomes the new provisions in § 9 KfWV.<sup>841</sup> It

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<sup>838</sup> European Commission, Decision of 27 March 2002, E 10/2000, Germany. *Anstaltslast und Gewährträgerhaftung*, pp. 11 ff., particularly, No. 2.d, last dash: “Financing, which the special credit institution grants at the request of the State on the basis of a law or a State directive to persons, which fulfil the conditions laid down in provisions of social law (e.g. educational situation, [...]).”

<sup>839</sup> See European Commission, Decision of 24 July 2009, C 15/2009, *Hypo Real Estate*, Germany, para. 47. This requires a case-by-case assessment whether the aid to KfW’s benefit is altered within the meaning of Article 108 TFEU. In that respect, it is decisive how § 2(1) KredAWG was applied so far (as the legal transposition of Accord II); cf. ECJ, Judgment of 16 September 2010, C-537/08 P, *Kahla Thüringen Porzellan v. Commission*, [2010] E.C.R. I-12917, paras. 44 ff.; see also *v. Wallenberg/Schütte in: Grabitz/Hilf, Das Recht der Europäischen Union*, Supp. 44 (May 2011), AEUV Art. 108, para. 15.

<sup>840</sup> ECJ, Judgment of 6 April 1995, C-241 and 242/91 P, RTE and ITP (“Magill”), [1995] E.C.R. I-743; Judgment of 29 April 2004, C-418/01, *IMS Health*, [2004] E.C.R. I-5039.

<sup>841</sup> Verordnung vom 20. September 2013 zur Anwendung von bankaufsichtsrechtlichen Vorschriften auf die Kreditanstalt für Wiederaufbau sowie zur Zuweisung der Aufsicht über die Einhaltung dieser Vorschriften an die Bundesanstalt für Finanzdienstleistungsaufsicht (KfW-Verordnung – KfWV), BGBl. 2013 I No. 59, p. 3735.

also considers the clear separation indispensable between legal supervision and the Ministry's divisions which define the development policy. At present, such a division is at least formally provided for already. The Ministry is generally in a position to supervise KfW's adherence to the legal rules that apply during its economic activities. However, it not only participates in the development of development policy but, according to the European Commission's findings, also has itself economic control of KfW.<sup>842</sup> Thus, a conflict between the general-interest and the entrepreneurial objectives of KfW can in principle be prolonged at the level of the Ministry.

**2040.** With respect to the other development banks, in contrast, State aid concerns arise only to a limited extent. According to the information available, these institutions generally cling more to their traditional development mandate and have only isolated activities where it is called into question whether they pursue a legitimate general-interest mandate.<sup>843</sup> However, concerns arise also at the level of the *Länder* in so far as individual *Landesbanken* pursue development activities under a common roof and continuously benefit at these activities from the liability in case of default and the maintenance guarantee (BayernLB, Helaba).<sup>844</sup>

**2041.** Finally, the Monopolies Commission also in the present context calls for an unequivocal alignment of the development banks' activities with Articles 106(2), 107 TFEU.<sup>845</sup> If KfW or other development banks were to ignore the restraints associated with these provisions, this could amount to a violation of State aid law under the circumstances and also to an abuse of market power (Article 102 TFEU, also in conjunction with Article 106(1) TFEU).<sup>846</sup> The Monopolies Commission moreover recommends with regard to KfW:

- The guarantee in case of default and the maintenance guarantee should be reviewed for whether they continue to be justified to the present extent in the future, taking into account KfW's activity profile. In particular with regard to its export financing activities, it is necessary that the rendering of development and market services under one common roof is reviewed with regard to its compatibility with European State aid law.
- The advertising work of KfW should generally be limited to informing the public about development options, measures and objectives. It does not raise concerns if KfW points to itself in a neutral fashion as the financing source. However, it should not be permitted brand management activities geared towards the competition.

With regard to the development banks in the *Länder*, the Monopolies Commission recommends that the development activities be outsourced from those *Landesbanken* that continue to be active as development banks, in order to rule out that the liability guarantees for the development activities have an effect on other business.

### 4.5.3 *Intermediate result*

**2042.** The Monopolies Commission assumes that the banks belonging to the savings bank group probably no longer benefit from the advantage associated with the liability in case of default and the maintenance guarantee (*Anstaltslast* and *Gewährträgerhaftung*). The provisions in the savings bank acts concerning the use of surplus profits and the included tax exemptions, however, appear to include

<sup>842</sup> See European Commission, Decision of 14 May 2009, COMP/M.5508, Soffin/Hypo Real Estate, paras. 18 ff. on the entrepreneurial control that the Federal Ministry of Finance exercises over KfW.

<sup>843</sup> Cf. para. 2027 above.

<sup>844</sup> Articles 4(5), 22 BayLBG; Articles 6, 8(4) Helaba Interstate Agreement. The situation for Nord/LB is different, see §§ 4(5), 7 Nord/LB Interstate Agreement.

<sup>845</sup> Cf. Monopolies Commission, XIIIth Main Report 1998/99, Competition Policy in Network Structures, Baden-Baden 2000, para. 127.

<sup>846</sup> See Dohms in: Schwarze, Daseinsvorsorge und Wettbewerb, 1st Ed. 2001, p. 56.

advantages relevant under State aid law, the justification of which is doubtful. Regarding the *Landesbanken*, it is necessary that the State aid rules are strictly observed. The same holds with regard to the development banks to the extent that they are not only active in the event of market failure (KfW, in particular).

#### ***4.6 Continuing the opening-up of the savings bank group for potential privatisations***

**2043.** The Monopolies Commission welcomes the initiatives that took place to open up the savings bank group for private investors in the years preceding the financial crisis. It notes that initiatives for legislation so far are able to safeguard the development of the savings bank association in conformity with the competition rules. It takes the concerns seriously that politicians articulated against a further opening-up of the savings bank association, but eventually still considers a broader opening of the savings bank group to be necessary to make possible an economically more efficient pursuance of activities in the general interest.

##### ***4.6.1 Developments so far in the direction of possible privatisations***

**2044.** The issue of participations in the member institutions of the savings bank group became topical due to the efforts of politicians at the level of the *Länder* to make concentrations possible to enable the controlling entities to render the savings bank association more flexible and to strengthen it.

**2045.** The delineation of the public banking system on the one hand and the rights of the non-public competitors on the other hand is difficult, in relation to both investments across the boundaries of the three-pillar structure and certain privileges that are reserved to the banks belonging to the savings bank group (e.g., the protection of the “*Sparkassen*” denomination pursuant to § 40 KWG). In essence, the issue is how far the State’s rights extend to develop and shape its public property.

**2046.** Politicians pursued the opening-up of the savings bank group for investments across the pillars before the financial crisis by transforming member institutions into stock corporations or tendering them for sale (in that regard, HSH Nordbank already has a private investor).<sup>847</sup> Acquiring an interest in the still public *Landesbanken* has become possible in the meantime as well, though frequently only public legal persons are allowed to become controlling entities. In addition, provisions for the transfer of shares in the share/controlling capital of savings banks to private individuals and for investments without control were included in the savings bank acts in several *Länder*.<sup>848</sup> The provisions for the transfer of shares to private individuals, however, have regrettably been removed again to a large extent in the meantime.

**2047.** The savings bank associations take a critical position towards the opening of the group for private investors due to strategic business considerations. Nevertheless, the group itself has recently entered into negotiations concerning the sale of an insurer of the group to private investors, though these negotiations were later adjourned (= abandoned?) due to political intervention.<sup>849</sup>

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<sup>847</sup> See § 1 Interstate Agreement of 23 May 2003 on the merger of Landesbank Schleswig-Holstein Girozentrale and Hamburgische Landesbank – Girozentrale (HSH Nordbank); Article 2 in conjunction with Annex of European Commission Decision 2005/345/EC of 18 February 2004, OJ L 116, 30 April 2004, p. 1, and press release IP/06/870 of 28 June 2006 (Bankgesellschaft Berlin); resolution of the municipal council of Hansestadt Stralsund of 11 December 2003 on a request pursuant to § 22 Kommunalverfassung MV (reference: Wikipedia entry “Sparkasse Hansestadt Stralsund”) (Sparkasse Stralsund); on the other hand, see Köhler, In die Normalität zurückgekehrt, FAZ, 20 September 2010 concerning the sale of the city’s shares in Frankfurter Sparkasse, a free savings bank, to Helaba.

<sup>848</sup> §§ 21 ff. HessSpkG.

<sup>849</sup> No author, Sparkassen bestätigen möglichen Verkauf (Provinzial Nordwest), Handelsblatt v. 04.12.2012; Drost, et al., Allianz scheitert an Politik in Nordrhein-Westfalen, Handelsblatt, 11 December 2012, p. 29.

**2048.** The Monopolies Commission supports the measures adopted so far in principle, but is concerned that the State occasionally reserves rights at the arrangement of those measures, which may unduly interfere with the market freedoms of the private market participants.

**2049.** The State is clearly free to define a public-interest mandate for reasons of the common good for the credit economy, and to decide whether it leaves fulfilment of this mandate to the private and cooperative banks or also maintains a public banking system to that purpose.<sup>850</sup> If it entertains a public banking system and then decides to open up the public banks for other investors, however, it must respect the rules on the European internal market, especially the European market freedoms.<sup>851</sup> The market freedoms provide that the public and private capital investors must be treated equally unless EU law itself or compelling grounds in the common interest recognised by it are in conflict with such equal treatment.

**2050.** This principle was observed by the legislatures in the *Länder* – as far as can be seen – when they opened the *Landesbanken* for private investors. The possibility of a complete transfer of the bank assets to private investors is already foreseen in the legal bases of Bayerische Landesbank and Nord/LB (so-called privatisation in substance).<sup>852</sup> These provisions do not provide for special public rights, but they provide that the acquirer be entrusted with the fulfilment of the institution's public-interest mandate by way of a transfer of duties. The tasks with which the acquirer is entrusted are or shall be defined by sovereign act in a way that the continued supervision of the fulfilment of the public-service mandate is warranted.<sup>853</sup> Another approach has been used at HSH Nordbank, which was transformed into a stock corporation with public majority (so-called privatisation by form). No public special rights were in this case reserved either. The public-service mandate of HSH Nordbank is defined in an interstate agreement and the charter. The *Landesbank's* obligation to pursue this mandate, however, could be altered or abolished through an amendment to the charter following the transfer of the participating *Länder's* shares to a new majority owner.

**2051.** In several savings bank acts, private investors have additionally been provided with the option to acquire an interest in the savings banks. These laws mostly provide that private capital investors can only acquire a (regular) silent interest, profit-sharing rights or second-tier subordinate capital in the savings banks whereas control continues to remain with the public entities controlling the savings banks.<sup>854</sup> These provisions do not give rise to concerns and must be supported as they make accessible additional capital for the savings banks. Up to the Brussels Concordance, the municipal controlling entities alone had the responsibility for providing contingency funds as capital at the creation of a savings bank. The Brussels Concordance allows the controlling entities to finance the savings banks only within the boundaries of EU State aid law. The issuance of subordinated capital and the sale of profit-sharing rights and silent participations enables the savings banks to compensate for possible financing gaps that may potentially arise due to the abolition of the State liability guarantees.

**2052.** In some savings bank acts, however, other investors were also provided with the option to invest in shares of the savings banks, which confer control to the shareholder. The acquisition of private

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<sup>850</sup> Articles 14, 345 TFEU.

<sup>851</sup> Cf. Attorney General Maduro, Opinion of 6 April 2006, C-282/04 and C-283/04, *Commission v. Netherlands*, [2006] E.C.R. I-9141, para. 29. See also Müller, [2005] ZögU 327 (342 ff.), broadly to the legal conditions for an opening of the public banks to private investors.

<sup>852</sup> Articles 1a, 3(1)(2) BayLBG, § 3(3) Interstate Agreement of 22 August 2007 on Norddeutsche Landesbank - Girozentrale -; likewise § 26c SpkG RP as to the Landesbausparkasse; narrower § 4(7) LBWG (only private entities in which only the entity controlling the *Landesbank* holds an interest). The provisions on privatisation in § 3 BerlSpkG are obsolete due to the resolution of Landesbank Berlin.

<sup>853</sup> Article 3(2) BayLBG, more open § 3(3)(4) Interstate Agreement of 22 August 2007 on Norddeutsche Landesbank - Girozentrale -.

<sup>854</sup> In Rhineland-Palatinate and the Saarland, however, the silent partners also have limited participation rights under the law of the *Land*, which exceed their rights pursuant to §§ 230 ff. HGB, see §§ 21a SpkG RP, 26 ff. SSpG.

investments through shareholdings is by law currently still possible in Berlin, Bremen and Saxony. In Bremen and Saxony, the possible shareholding is restricted to less than 50% of the shares.<sup>855</sup> In Hesse, also Public controlling entities not seated in the Land and not established under the law of the Land can acquire shareholdings in a savings bank.<sup>856</sup> These provisions contain in part limitations on the market freedoms, which gives rise to concern. This holds in particular for the limitation on the amount of the shareholdings in Bremen and Saxony and the limitation to public controlling entities in Hesse, without these entities being subject to the competence of the legislature in the *Land* to create and organise such entities.<sup>857</sup> These limitations cannot be justified with legislature's economic interests in the Land, in particular not with an interest in the protection of the existing competitive conditions for the savings banks.<sup>858</sup> Equally, no justification follows from regional or social policy considerations if the law does not contain any objective and precise criteria in that regard.<sup>859</sup> The Monopolies Commission underlines that the aforementioned limitations are inapplicable under EU law if they cannot be justified. It recommends that these limitations be abolished.

**2053.** In contrast the agreement reached with the European Commission on the protection of the “Sparkasse” denomination under § 40 KWG has to be welcomed. The Commission had started an investigation based on the suspicion that the provision unduly interfered with the freedom of capital and establishment.<sup>860</sup> For the “Sparkasse” denomination is not (only) a brand, but in particular a category assigned to certain credit institutions in the public interest under the prudential rules. According to the agreement, Germany must apply § 40 KWG in a way that does not violate the market freedoms, but it can impose public-service obligations on privatised savings banks in order to safeguard the character of the savings banks as credit institutions serving the public interest.<sup>861</sup>

**2054.** Against this background, in principle, no reason exists for the occasionally voiced concerns that the enforcement of the market freedoms in the area of the savings banks could jeopardise the provision of credit services across the country. The State, notably the municipalities, can have the task to ensure the provision of these services. That said, the option for private investors to acquire an interest strengthens the freedom of the municipalities to decide themselves how they finance the provision of credit services. The enforcement of the market freedoms can thus not least contribute to the provision of services in the local public interest.<sup>862</sup>

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<sup>855</sup> See § 3(6) BerlSpkG, § 53(1)(3) SächsKredInstG, § 3b BremSpkG (the necessary corporate change of Sparkasse Bremen has taken place). In Hessen, there is only the option of a silent partnership within the meaning of §§ 230 ff. HGB (§ 22 HessSpkG).

<sup>856</sup> § 1(4) HessSpkG; similar § 4 Abs. 5 SpkG SH until recently. In Saarland, see moreover § 28 Abs. 1 SSpG pursuant to which savings banks can be merged with savings banks from outside the *Land*.

<sup>857</sup> See, e.g., ECJ, Judgment of 11 November 2010, C-543/08, *Commission v. Portugal*, [2010] E.C.R. I-11241, paras. 43, 47; Judgment of 2 June 2005, C-174/04, *Commission v. Italy*, [2005] E.C.R. I-4933, para. 32, which should require the equal treatment of private and public undertakings. The Monopolies Commission is aware in this context that the European Commission had indicated in a non-binding manner that Article 345 TFEU applied to corporate changes that take place exclusively in the area of public undertakings; see Letter of Commissioner McCreevey of 2006 to the *Land* Hessen (not published), citation: Becker, [2010] ZG 260 (271, fn. 38).

<sup>858</sup> ECJ, Judgment of 8 July 2010, C-171/08, *Commission v. Portugal*, [2010] E.C.R. I-6817, para. 70; European Commission Communication, Intra-EU investment in the financial services' sector, OJ C 293, 25 November 2005, p. 2 (4).

<sup>859</sup> ECJ, Judgment of 15 March 2003, C-463/00, *Spain v. Commission*, [2003] E.C.R. I-4581, paras. 70, 80; see also Judgment of 23 October 2007, C-112/05, *Germany v. Commission*, [2007] E.C.R. I-8995, paras. 70, 74; Judgment of 8 July 2010, C-171/08, *Portugal v. Commission*, [2010] E.C.R. I-6817, paras. 75-76.

<sup>860</sup> European Commission, press release IP/06/870 of 28 June 2006; Henneke/Wohltmann, [2006] *Der Landkreis* 790 ff.; Witte/Gregoritza, [2007] *WM* 151 ff. with references to the materials relating to the proceedings, which were partially not published.

<sup>861</sup> According to the speaker Mirow of the Federal Ministry of Finance, in his reply to a request of Deputy Dreibus (Die Linke), BT-Ds. 16/3894.

<sup>862</sup> Article 28(2) GG; see also Article 14 TFEU, Article 1 Protocol No. 26 to the Treaties, OJ C 115, 9 May 2008, p. 308.

This being said, the Monopolies Commission has to take note of the fact that strong political concerns continue to exist about the opening of the savings bank group for private investment. In the following section, it discusses in more detail the arguments advanced by politicians in that regard.

#### ***4.6.2 Privatisation option for a better implementation of the general interest***

**2055.** Privatising public credit institutions has been an emotional issue for politicians for years. The critics of a more pronounced opening base their arguments essentially on the general-interest mandate that is pursued by the public banks. It is viewed as an element of these activities that the banks are allegedly relatively independent from narrow commercial profit interests due to their mandate; in contrast to the purely profit-focused private banks. In addition, politicians view the savings banks and the *Landesbanken* as an instrument to make investments that are desirable from a regional, employment or social policy perspective. Any further opening of the savings bank group for private participations would trigger an irreversible privatisation process that would in the end kill the public banks and destroy the established three-pillar structure. In particular with regard to the savings banks, the following reasons are put forward for this development:<sup>863</sup>

- Opening the savings banks for private participations beyond silent shareholdings or profit-sharing investments would already be a (partial) privatisation of the relevant savings banks. A precedent would be established that would open competition for controlling interests beyond the limits of the three-pillar structure (self-selling argument).
- In view of the often desolate financial situation of the municipalities, one could already see that the municipalities could not resist the temptation at some point to strengthen their income in the short term. The *Länder* legislatures would consciously take this risk into account when opening up the savings banks for privatisation, for a sale would only be made possible by someone who is interested in selling or has accepted this option (cashing-in argument).
- Following privatisation, the fulfilment of the savings banks' public service mandate could no longer be ensured. This would not change if obligations in the common interest were placed on the private acquirer of the savings banks. For the savings banks' public-service mandate is said to depend too much on the situation in the individual case for an effective supervision to be possible in order to ensure the implementation of the general-interest obligations. Moreover, due to their profit interest and for lack of democratic control, private undertakings would never submit to the implementation of the general-interest mandate as the savings banks do (welfare State argument).

Against this background, the critics of a farther-reaching opening consider it to be irresponsible and disproportionate to use individual instances where the savings banks or *Landesbanken* or their controlling entities have failed as grounds for putting the public benefit associated with the public banking system and to subscribe to privatisation concepts that are "ideologically motivated in their entirety". If anything, then the political control of the public banks would have to be improved and to be made more comprehensive.

**2056.** The Monopolies Commission understands the fears related above, but considers them to be unjustified or exaggerated. The Monopolies Commission underlines that the fundamental concerns articulated by it and its members against the State's meddling with the economy continue to be valid. It is not the institution's interest to question the State's liberty to organise public ownership. The organisation of the property in the savings banks is not its priority in the present context. Rather, the

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<sup>863</sup> See, e.g., Troost/Mathes, [2007] *Blätter für deutsche u. internationale Politik* No. 7, 867; Min.-Präs. Stegner, *Unsere Sparkassen erhalten!*, press release of 23 January 2013 of the SPD faction in *Landtag Schleswig-Holstein*.

issue is that the competitive efficiency of the existing banking system must be improved and that at the same time it must be taken care that the special mandate of the public banks is fulfilled in accordance with competition principles.

**2057.** The starting point for competition policy must be that the State, as a general postulation, acts in accordance with the principle of competition if and to the extent that it participates in competition.<sup>864</sup> Exceptions may only exist where the State pursues a common-interest mandate. In that regard, no obligation exists for the State – as is noted above – to only act where private parties cannot do better. That said, the State has to limit its interference with competition to what is necessary to provide services in the general economic interest.<sup>865</sup> The savings bank group, too, can therefore generally only be developed further within the framework of competition. Maintaining the existing structures designed by public law is not indispensable in that regard.<sup>866</sup> The main competitors of the savings bank group (cooperative banking association, Postbank) likewise operate a powerful, locally and regionally oriented banking business without having the State in the background, and could effectively fill potential gaps in the provision of credit services. Against this backdrop, the further development of the savings bank group must centre on its business and the adaptation to the market, but should still also align the savings bank group strictly with its public mandate and the political initiatives that the controlling entities set with regard to the public mandate of the group. As is being highlighted throughout this Report, the role of the savings bank group in competition and the role of its controlling entities in defining the public mandate of the group must be distinguished much more clearly.

**2058.** The Monopolies Commission explains in the previous sections of this chapter that the existing association structure partly supports the business of the savings bank group, but partly also hinders its legally mandated alignment with competition principles. To the extent that individual group members suffer from efficiency and financing problems, it must be assumed that a more flexible structure would allow them to adapt to competition in an economically advantageous and legally innocuous fashion. It must be acknowledged that the savings banks themselves continuously work at adequately matching their activities in competition and their obligations in the common interest. Thus, during the financial crisis the DSGV abandoned previous target profits of 15%, which only would have been achievable through a much more market-oriented strategy, if at all, and replaced them with a more balanced combination of targets where common interest aspects can be accounted for to a larger extent (return on equity dependent on the situation, increase in principal bank relations, client coverage, client satisfaction). In this context, concern does not arise that the DSGV clings to a cost-income ratio of 60% because the common-interest objective is mostly relevant when it comes to the use of proceeds (though this does not exclude the use of proceeds for unprofitable business that is in the common interest).<sup>867</sup> The activities in competition, however, in any case only require economic expertise and not the interference of politicians.

**2059.** Politicians should rather see its role in clearly defining the public mandate of the savings bank group and in ensuring the fulfilment of that mandate where the orientation of the savings banks on the market conditions is associated with the risk that the public-interest mandate is insufficiently fulfilled from the perspective of the controlling entity. Such a risk, however, would regularly arise in particular where the market forces apply clearly whereas the public mandate is defined only vaguely.

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<sup>864</sup> Cf. § 130(1) GWB; Monopolies Commission, Special Report No. 27, System Competition, Baden-Baden 1998, paras. 5 ff.

<sup>865</sup> See Article 106(1), (2) TFEU; and para. 1821 above.

<sup>866</sup> This would also not be in line with the situation in other Member States, cf. Landesbank Hessen-Thüringen, Im Spannungsfeld zwischen Wettbewerb und politischer Gestaltung: Helaba-Studie zur Entwicklung des Sparkassenwesens in Europa, published on 12 February 2008, pp. 13, 23, 31, 40.

<sup>867</sup> Cf. the Monopolies Commission recommendation in para. 1803 to limit the savings banks' public mandate to securing the provision of credit services beyond what is already available on the market.

Consequently, it is above all the responsibility of politicians to develop the savings bank system further in a way that avoids putting the operation of the savings banks in the common interest at risk.

**2060.** The option of involving private parties in the member institutions of the savings bank group would probably have a disciplining effect on the business activities of the savings bank group in the sense that it group members structure the cooperation within the group in a more efficient way. At the same time, it cannot be regarded as a necessary corollary that the savings bank system or the fulfilment of the associated public mandate would have to be jeopardised by the participation of private parties up to privatisation in substance:

- The responsibility for meeting public-service obligations would stay with the controlling entity and would have to be enforced also vis-à-vis a private acquirer of a member undertaking of the savings bank group. The possibility to enforce the public mandate would depend on how supervision over the institution is structured, in which the private stakeholding exists (*re* self-selling argument).
- The controlling entity would know that it can privatise completely only once. A controlling entity that implements the privatisation in an irresponsible fashion would probably also fail in responsibly ensuring that the public mandate is met in the future, if the privatisation were prohibited. In contrast, responsible entities would select the private acquirer prudently and would take care that the public mandate is met continuously (*re* cashing-in argument).
- Lastly, a private acquirer of a group institution would have to carefully balance whether the specific advantages associated with the acquisition (membership in the association, use of the brand, legal privileges such as, *gilt-edging*<sup>868</sup>) outweigh the restrictions associated with the public mandate. In addition, private investors would have to take into account that they are subject to relatively stringent supervision because the grant of the privileges reserved for the savings banks might otherwise not be justified any further (*re* welfare State argument).

**2061.** A participation associated with control would require effective supervision in order to permanently ensure that the fulfilment of the public mandate. This problem, however, is solved in a satisfactory way in the legal bases of Bayerische Landesbank and Nord/LB, which already provide for potential privatisation in substance.<sup>869</sup> In that context, the supervision regarding the fulfilment of the public-interest mandate is organised in the same way regardless of whether the controlling entity is public or private, and it encompasses the usual supervisory instruments to ensure that the objectives of supervision can be met also in the individual case. No reason exists for the assumption that additional intervention rights are needed to ensure that the public-interest mandate is implemented.

**2062.** When the Monopolies Commission advocates the further opening-up the savings bank group vis-à-vis private investors, however, the pivotal factor is that the drawbacks of the restrictions of private investors appear to outbalance the benefits of the hitherto defended and exclusively State-controlled development of the savings bank system. For instance, evidence exists of continued substantial inefficiency (see para. 2063) and of an implementation by the savings banks of their public mandate that does not always stand to reason – from a competition-policy perspective (see para. 2064).

**2063.** Concerning the existing inefficiency, it must be repeated that the savings bank group achieves its returns using forms of cooperation in its association that are anticompetitive in various respects.<sup>870</sup> Apart from that, more and more costly misdirected investments have taken place that can be traced

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<sup>868</sup> See § 1807(1) No. 5 of the Civil Code.

<sup>869</sup> Article 3(1)(2) BayLBG, § 3(3) Interstate Agreement of 22 August 2007 on Norddeutsche Landesbank - Girozentrale -.

<sup>870</sup> See Sections 4.3-4.4 above.

back to a lack of adaptation to the market conditions. The fate of several *Landesbanken* in the financial crisis marks a sad climax in that regard.<sup>871</sup> However, also the costly acquisition of Landesbank Berlin by the savings bank group and economically pointless projects of individual savings banks (e.g., the establishment of a media hub in Cologne by Sparkasse Köln-Bonn) should be recalled in this context.<sup>872</sup> The costs of this inefficiency are commonly not addressed during the strident defence of the public banking system, but are silently handed on to the taxpayers, and in the case of the *Landesbanken* – by means of lay-offs – to the employees of the respective institutions.

**2064.** Likewise, reason exists to question the pursuance by the public banks of their public mandate. This holds notably in relation to the savings banks' mandate to ensure the supply of credit services, in particular if that mandate is understood as broadly as it is formulated in the savings bank acts. In the Stuttgart declaration (*Stuttgarter Erklärung*) on investment advice (2010), one can read:

“The client is with its objectives and demands at the centre of the advice. [...] Simple product commercialisation without the observance of the interests of the client cannot be reconciled with the philosophy of the savings banks.”

It must be stressed that this self-commitment is a matter of course, which traces only the legal obligations regarding investment advice which all banks have to observe.<sup>873</sup> Nonetheless, according to press reports many savings banks have sold highly risky and sometimes ethically questionable investments to their customers against high commission, without informing the customers of their functioning and risks.<sup>874</sup> Further, to the extent that the savings banks provide additional services beyond the offers of the competitors, for example, by running basic accounts or accounts exempted from the attachment of wages (“P accounts”), they ask for high fees which must be borne by the customers, who frequently have no choice and depend on these products.<sup>875</sup> For regular banking services as well, the savings banks ask for fees that are sometimes legally questionable (e.g., fees for credit account statements or for failed account operations for lack of funds) or lie significantly above the fees of other banks (e.g., for withdrawals at cash machines).<sup>876</sup> This conduct persistently gives rise to significant additional costs for the consumers.

**2065.** The supervision of the savings bank group by politicians appears insufficient in regard of these significant deficiencies. The lack of supervision, however, is only partially due to the fact that the legislatures in the *Länder* place more importance on the needs of the savings bank group than on the individual concerns of the controlling entities, which have only a limited say vis-à-vis their savings banks under the law. What is more of concern is that the controlling entities have only insufficiently assumed responsibility when false investments or mismanagement became public. This, however, is

<sup>871</sup> See paras. 1437 ff., 1447 ff. above.

<sup>872</sup> As to the acquisition of Landesbank Berlin see, e.g., Drost, *Landesbank Berlin belastet Sparkassen*, *Handelsblatt*, 8 March 2013, p. 29; and as to the savings banks' failed investments, e.g., Dönch/Körner/Spilcker, *Wie heil ist die Sparkassen-Welt?*, [2009] *Focus Magazin* No. 34; Bergermann/Welp, *Vertreibung aus dem Paradies*, [2013] *Wirtschaftswoche* No. 17, p. 44 ff.

<sup>873</sup> Against this backdrop, the deficiencies in banking advice recently found at the German banks in general give rise to some concerns; Federal Ministry of Justice and Consumer Protection, *Beratungsprotokolle sollen qualitativ hochwertige Beratung sicherstellen*, press release of 22 June 2014; Frühauf, M., *Viele Anlageberater schummeln*, *FAZ*, 24 June 2014.

<sup>874</sup> Bognanni, *Kundennah, konservativ, kaltblütig*, *Handelsblatt*, 13 March 2013, p. 4; no author, *Sparkassen droht Klagewelle*, *Handelsblatt*, 12 March 2013; Reimann/Bergermann, *Mit diesen Tricks verkauften Banken windige S&K-Fonds*, *Wirtschaftswoche*, 2/4 March 2013.

<sup>875</sup> BGH, Judgment of 13 November 2012, XI ZR 500/11 and XI ZR 145/12, P-Konten, [2013] *GWR* 45; OLG Magdeburg, Judgment of 31 January 2012, 9 U 128/11, Jedermannkonto, [2012] *ZIP* 1119.

<sup>876</sup> See BGH, Judgment of 13 February 2001, XI ZR 5/97, *Lebensversicherungen*, [2001] *WM* 563; Verbraucherzentrale Bundesverband, press release of 21 March 2013 as to LG Frankfurt/M., Judgment of 6 March 2013, 2-02 O 274/12 (not final); and already Monopolies Commission, *XIXth Main Report 2010/2011, Strengthening Competition in Retailing and Services*, Baden-Baden 2012, para. 599, as to the transaction fees at cash machines.

not surprising given the close personal links between the savings banks and politicians and the financial benefits for both sides, which accompany these links.<sup>877</sup> Additional control by the public is apparently possible only to a very limited extent. It probably must be considered a serious structural shortcoming that the political representatives, on the one hand, freely define the common interest which is to be pursued by the savings banks and, on the other hand, are allowed to pursue their own commercial interests while sitting on the board of administration and monitoring the fulfilment of the common interest.

For general considerations, the Monopolies Commission anyway recommends that the definition of the savings banks' public mandate by politicians and the exercise of supervisory functions in the board of administration of the savings banks are personally separated from each other.<sup>878</sup>

### 4.6.3 *Intermediate result*

**2066.** The Monopolies Commission welcomes the initiatives which were taken in the years prior to the financial crisis to open up the savings bank group for private investors and, thereby, to strengthen the savings bank group financially. That said, it emphasises that such an opening must take place in accordance with the market freedoms. The investment rules in some *Bundesländer* (Bremen, Hesse and Saxony) raise concerns in that regard.

**2067.** The Monopolies Commission understands the fears in case of a continued opening of the savings bank group, but considers them to be unjustified or exaggerated. Such an opening can take place in a way that the savings bank groups' operation in the common interest is ensured permanently. The exclusively public control, which exists at the present time, is not satisfactory from the perspective of economic efficiency as well as regarding the pursuance of common interests. Better supervision of the savings bank group appears to be prevented not least by the close links between the group and politicians. The Monopolies Commission recommends that the political definition of the public mandate and the exercise of supervisory functions in the board of administration of the savings banks be personally separated from one another.

## 5 *Financial products and transactions*

### 5.1 *General market situation*

**2068.** Competition in financial products is heavily influenced by the structural conditions existing on the financial markets, that is, intensive regulation and, in Germany, the three-pillar structure of the German banking system. The standardised credit business is marked by strong competition whereas the situation of more complex products is in some respect more difficult to appraise.

**2069.** In the financial business in Germany, the delayed consolidation ("overbanking") is a heavy burden on market development. On the whole, German banks hold their ground in competition quite well, but retail banks, in particular, frequently generate little profit. Thus, many domestic banks also engage very little on growth markets.

**2070.** However, the market is changing. Demand is becoming more differentiated both in retail banking and in banking for smaller and larger corporate customers. At the same time, the pool of competing suppliers is becoming larger, again both in private banking (e.g., through suppliers of

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<sup>877</sup> As to the issue of missing sector-specific expertise in the supervisory institutions of savings and cooperative banks, see moreover Körner, et al., *Glas halb voll oder halb leer? Eine Analyse der Qualifikation von Kontrollorganmitgliedern deutscher Banken*, RWI Materialien, Heft 78 of May 2014.

<sup>878</sup> In addition, it must be reiterated that a more pronounced illustration of the general-interest activities in the public institutions' marketing and their business reports could improve public control of whether the banks fulfil their public mandate; see paras. 1805, 1811 above.

“ethical banking” and other niche services) as well as corporate banking (e.g., through shadow banks); commodity retailers and Internet companies populate the market in addition (e.g., as financial services providers).<sup>879</sup> The banks do not appear to have completed their own analysis of these market changes.<sup>880</sup> It is clear that banks will have to adapt their business models to become more innovative throughout the entire value-added chain.<sup>881</sup> This implies, for example, for retail banks that they will have to face up to increasing competition from the Internet. It can be predicted that customers will shift their demand for standard services more and more to the Internet, but that they will continue to seek personal advice – preferably in a branch – for services requiring substantial explanatory support. The cost of branch retail banking, however, are a significant challenge.<sup>882</sup> Market participants therefore expect that banks will hardly be able to defer further consolidation, that branches will be merged, and that the trend for low-cost banking services will shift from complex combined products to simple standard products.<sup>883</sup> At the same time, banks will have to address customer needs in a much more targeted and differentiated fashion. Otherwise, they will not be able to make customers pay for the additional cost of value-added services and will lose frustrated customers permanently. Thus, organising advisory services will become more complex, and will give rise to additional and not yet foreseeable regulatory questions.<sup>884</sup>

**2071.** Hence, an appraisal of the competitive situation regarding financial products and transactions is difficult. There is a risk that individual statements will be outdated quickly. This Report, however, focuses on market conditions and less on changes with respect to individual financial services.

**2072.** Regarding market conditions, it is pointed out above that banks are financial intermediaries, thereby occupying a middle position between depositors/investors and loan recipients. Regularly, banks and other financial intermediaries also hold an interest in the platform infrastructures used for financial transactions (e.g., payment systems, Central Counter-Parties, the German stock exchange). In addition, the more financial products become complex, the more the importance increases of information asymmetries to the suppliers’ benefit. Those structural elements can be used for competition-restraining behaviour.

**2073.** The present section discusses several current market development. These reveal structural problems which, based on the available information, pose ideal conditions for anticompetitive behaviour.

## ***5.2 Cartelisation problems with regard to reference rates and other financial information***

**2074.** On a worldwide level, competition authorities have conducted investigations in several cases in the past few years, which concerned market manipulation by large international banks and other

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<sup>879</sup> See Steria Mummert Consulting/FAZ-Institut, Branchenkompass 2012 Kreditinstitute (November 2012); Roland Berger, Die Zukunft des Retail Bankings in Europa, study published on 11 October 2013; accessible: [www.rolandberger.de](http://www.rolandberger.de) ; Investors Marketing, Privatkundenvertrieb im Umbruch, IM-Trendstudie 2013; further: no author Einmal Kaugummis und ein Bankkonto, bitte!, Reuters/Handelsblatt, 16 October 2013 concerning the supply of simple bank services through kiosks in France (“Nickel”).

<sup>880</sup> See, e.g., Baches, Banken suchen Ertragsquellen der Zukunft, NZZ, 12 April 2013.

<sup>881</sup> As an example of an up-to-date study, see Boston Consulting Group, study: Getting Business Models and Execution right: Global Payments 2013; accessible [https://www.deutschebank.nl/nl/docs/BCG\\_2013\\_Global\\_Payments\\_2013.pdf](https://www.deutschebank.nl/nl/docs/BCG_2013_Global_Payments_2013.pdf).

<sup>882</sup> According to news reports, the branch infrastructure accounts for roughly 45-50% of the cost associated with private banking; see Neuhaus, Banken suchen eine neue Strategie, Tagesspiegel, 15 September 2013.

<sup>883</sup> Such a development is also desired on principle, though this is not always reflected in the regulation; see European Parliament, DG Internal Policies, Consumer Protection Aspects of Financial Services, study PE 507.463, February 2014, pp. 13, 77, 100.

<sup>884</sup> E.g., regarding data protection, cf. IBM Global Business Services, The Real-World Use of Big Data, Executive Report, October 2012.

financial market players, and which partly have already been concluded. Those manipulations concerned:

- several reference rates for interbank transactions (Euribor, Libor)<sup>885</sup>,
- one (additional) reference rate for interest derivatives (ISDAfix),
- reference rates for currencies<sup>886</sup>, and
- financial information on CDS and the foreclosure of the market for CDS clearing and exchange services.<sup>887</sup>

The CDS investigation, however, was into a suspected cartel which differed from the other cases referred to, and which is therefore not discussed here any further. In addition, there is a suspicion that cartel manipulation may have taken place in relation to some raw materials, and that both banks (noble metals, aluminium) and non-banks (crude oil) may have participated in those manipulations.<sup>888</sup>

**2075.** The participants in such manipulations apparently included in many cases institutions seated in Germany, at least Deutsche Bank. The latter apparently also participated in manipulations that concerned only non-European markets (i.e., the Californian electricity market).

**2076.** From a competition perspective, the revealed manipulations are the most serious infringements in the area of financial services, and probably rank among the most serious cartel infringements in general to date. The relevant reference rates have fundamental significance for multiple financial products. For example, credits with variable interest rates are often linked to the reference rates for interbank loans, that is, among others, roughly 40% of consumer loans according to EU estimates.<sup>889</sup> The aforementioned reference rate is being used to determine the execution values for cash-settled swap options, but also to determine prices for bonds and other securities.<sup>890</sup> There is, however, concern that the coordination affected to the greatest extent the foreign exchange markets, taking into account that foreign exchange transactions have a daily volume of roughly USD 5.3 trillion (= EUR 3.9 trillion).<sup>891</sup>

**2077.** In all cases that have been detected so far, the benefits of cartel coordination were for the participating banks probably significantly higher than the associated risks. On the one hand, the relevant reference rates are central for the financial economy. Deutsche Bank, for instance, generated profits of more than EUR 500 million with Libor-based and similar transactions only in 2008, as is said to follow from internal documents.<sup>892</sup> Consequently, high profits were promised by rather modest

<sup>885</sup> Particularly, Yen-Libor and Euro-Euribor, moreover the Japanese Tibor, though to a smaller extent (at least in so far as EU markets were concerned). The ISDAfix manipulations additionally referred to were independent from these manipulations; hence, they are here listed separately.

<sup>886</sup> In the EU, an investigation is currently running in relation to products with CHF nominal values; European Commission, MEMO/13/1090 of 4 December 2013.

<sup>887</sup> European Commission, COMP/39.730, CDS (Credit Default Swaps) - Clearing and COMP/39.745, CDS – information Market; see also Value Recovery Fund LLC v JPMorgan Chase et al., S.D.N.Y., 13 CIV 4928, Complaint of 16 July 2013; Carney, The EU's Odd Antitrust Case Against the Banks, CNBC.com, 1 July 2013, who points to a potential connection to the issue of implicit guarantees in relation to these investigations.

<sup>888</sup> Regarding the manipulation of the gold price, a fine was already imposed on one major bank (Barclays), though only because of an individual infringement (no cartel); see UK FCA, press release of 23 May 2014.

<sup>889</sup> It is estimated that the Libor benchmark alone was the basis for products worth several hundreds of trillions of USD in the investigated period, cf. Wheatley Review of Libor, Final Report (Sept. 2012), para. 1.11 (USD 300 trillion), BIS as quoted in US DOJ, press release of 19 December 2012 (USD 450 trillion).

<sup>890</sup> It is estimated that the reference rate for interest derivatives is the basis for products with a nominal value of USD 379 trillion.

<sup>891</sup> BIS, Triennial Central Bank Survey 2013, Foreign exchange turnover in April 2013: preliminary global results (September 2013). p. 3.

<sup>892</sup> Ertinger, Deutsche Bank soll halbe Milliarde im Zinshandel verdient haben, Handelsblatt, 10 January 2013.

modifications to the reference rates. In addition, the participating banks used the possibility of manipulating the reference rates for interbank transactions in order to conceal the negative development of interest conditions following the collapse of the interbank markets during the financial crisis.<sup>893</sup> In the context of the presumed forex cartel, it is estimated that it was possible to use the manipulations to generate additional profits of USD 500 million in transactions with a volume of USD 10 billion.<sup>894</sup> In contrast, the detection of manipulations was barely likely given the complexity of capital markets. The same holds with respect to painful sanctions, the more so as there was no precedent. The supervisory authorities, moreover, abstained from an ongoing monitoring of the determination of reference rates.

**2078.** The acting employees, on their part, were exposed to significant incentives for – non-coordinated or coordinated – market manipulation practices as this allowed them to gain information enabling them to conduct their own transactions in advance, or otherwise to generate additional profits. In addition, the acting traders could use the manipulations to conclude business that was to their personal advantage, whether by securing the prospect of an increased bonus or by using their own funds for speculation. These practices could even harm the employer institution when traders concluded a transaction to their personal advantage, but to the disadvantage of other business departments of the employer institution.

**2079.** The markets and competition authorities have started wide-ranging investigations at a worldwide level after the suspicion of reference rate manipulations first arose at the end of 2007 and materialised over the following years.<sup>895</sup> For instance, the investigation of the manipulation of reference rates for interbank transactions (Libor, etc.) meanwhile involves capital markets and competition authorities in multiple jurisdictions globally, whose investigations are focusing on particularly serious infringements concerning the relevant jurisdiction.<sup>896</sup> The suspected manipulations of reference rates for interest derivatives and forex reference rates has equally led to worldwide investigations, and these cases could, according to stakeholders, be even more significant than the case on the reference rates for interbank transactions.<sup>897</sup>

**2080.** The revealed manipulations have provoked a public outcry, and probably also have contributed to the loss of confidence in the banking industry. It is still to be seen whether the ongoing investigations will result in additional cartel charges. Nevertheless, the question must be raised whether the detected manipulations constituted isolated infringements. The Monopolies Commission

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<sup>893</sup> Snider/Youle, Diagnosing the LIBOR: Strategic Manipulation and Member Portfolio Positions, research paper of December 2009; accessible: <http://faculty.washington.edu/bajari/undergradiosp10/LiborManipulation.pdf>.

<sup>894</sup> Flütisch, Wie Banker Investoren um Milliarden brachten, Tages-Anzeiger, 5 October 2013; moreover, see Hässig, UBS entlässt 2 Toptrader in Devisenskandal, In\$ide Paradeplatz, 4 October 2013.

<sup>895</sup> As to the inception of the investigation, see Mollenkamp/Whitehouse, Study Casts Doubt on Key Rate, Wall Street Journal, 29 May 2008; Ellis, LIBOR Manipulation: A Brief Overview of the Debate, FTI Consulting, Document of 20 April 2011; accessible: <http://www.fticonsulting.com/global2/media/collateral/united-states/libor-manipulation.pdf>.

<sup>896</sup> Investigations have been conducted so far, among others, in the EU, the US, Australia, Brazil, Canada, Japan, Switzerland, and South Korea; see European Commission, Staff Working Document of 7 May 2013, SWD(2013), 159 final, p. 27. The authorities' investigations also concerned potential manipulations of banks not taking part in the cartels; see Mussler/Mußler, Banken im Visier der EU, FAZ, 11 December 2012. It is alleged that manipulations of the Libor benchmark took place as from 1991; see Keenan, as quoted in Bundestag, Britischer Finanzexperte berichtet von langjährigen Zinssatz-Manipulationen, press release of 28 November 2012. Similarly, manipulations of currencies are alleged to have occurred for at least ten years; Vaughan/Finch/Choudhury, Traders Said to Rig Currency Rates to Profit Off Clients, Bloomberg of 12 June 2013.

<sup>897</sup> Investigations concerning the manipulations of reference rate for interest derivatives are ongoing at least at various authorities in the EU and the US, concerning forex manipulations in the EU, Switzerland, and Asia (at least Hong Kong).

is concerned that some markets of the international financial business may be structurally disposed to cartelisation.

**2081.** The Monopolies Commission's concerns ensue from the following facts: In the relevant cases, (i) market conditions existed under which a coordination of company interests is usually more likely than not; (ii) the determination of reference rates required an information exchange that was capable of giving rise to serious competition concerns, and (iii) such facts required a high standard regarding organisation and conduct, the non-observance of which would necessarily trigger the liability of the respective banks and undertakings under the competition rules.

### *Market conditions were ideal for coordination*

**2082.** The manipulation of reference rates, and even more the formation of a cartel to that end, were originally thought barely feasible given the organisation of the process to determine those reference rates, and given the existing competition on the international financial markets. In reality, however, the participants were apparently able to pursue manipulative practices over lengthy periods and to organise them in cartels that were also stable over long periods (even beyond the periods covered by the investigations). Manipulations of Libor rates are said to have taken place since 1991.<sup>898</sup> In the case concerning foreign exchange rates, traders have said that manipulations took place on a daily basis and that such practices existed at least for ten years.<sup>899</sup> This appears to be due to the way the process to determine reference values was framed, and to the market conditions in general.

**2083.** The common criteria of competition law do not allow for the conclusion that certain market conditions give rise to cartelisation in the individual case. Nevertheless, it is accepted that existing conditions can provoke coordination if the benefits of such coordination exceed the benefits without such coordination.<sup>900</sup> The coordination does not have to be based on an agreement. It must, however, be simple and possible, permanently, to sustain the coordination because the coordinating firms are able to monitor to a sufficient degree whether the terms of coordination are being adhered to; because there is some form of deterrent mechanism that can be activated if deviation is detected; and because the reaction of outsiders (e.g., competitors, customers) is not able to jeopardise the results expected from the coordination.<sup>901</sup>

**2084.** In the present context, it is of no relevance that the markets where reference rates are used are often very competitive. In all cases where rate manipulations have been detected to date, one must distinguish between the market conditions in which the rates are determined and the market conditions in which they are used. The determination of reference rates constitutes a service upfront to the capital market transactions and other transactions where reference rates play a role. The market situation in which the rates are applied is therefore not relevant.

**2085.** The reference rates were frequently determined on the basis of transactional data or estimates provided by a relatively small number of financial institutions. For instance, up to 18 banks (Libor) or up to 43 banks (Euribor) participated in the determination of the reference rates for interbank transactions. In the case of Libor, however, reference rates had to be determined for 10 currencies in

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<sup>898</sup> Keenan, as quoted in Bundestag, *Britischer Finanzexperte berichtet von langjährigen Zinssatz-Manipulationen*, press release of 28 November 2012.

<sup>899</sup> Vaughan/Finch/Choudhury, *Traders Said to Rig Currency Rates to Profit Off Clients*, Bloomberg, 12 June 2013.

<sup>900</sup> Cf. European Commission, *Guidelines on the assessment of horizontal mergers under the Council Regulation on the control of concentrations between undertakings (Guidelines on horizontal mergers)*, OJ C 31, 5 February 2004, p. 5-18, paras. 40-41; similarly: *Guidelines on the assessment of non-horizontal mergers under the Council Regulation on the control of concentrations between undertakings (Guidelines on non-horizontal mergers)*, OJ C 265, 18 October 2008, para. 80.

<sup>901</sup> Cf. European Commission, *Guidelines on horizontal mergers*, para. 41; *Guidelines on non-horizontal mergers*, para. 81.

15 different durations. The situation in the case of Euribor was similar. Therefore, the participating banks met in different panels with varying composition, which included each between six and 18 banks. Inside these panels, it was always the same banks and participants who met together. In addition, not all submitted rates were used, but the submitted values were a basis to calculate an average value, excluding extreme values to a pre-defined extent (e.g., Libor: highest and lowest 25%). Thus, in case the banks did not make extreme estimates, there was a good prospect that the reference rate could be influenced by coordinated submissions. The determination of the reference rates for interest derivatives took place in a comparable fashion.

**2086.** The trade in foreign currencies is a business involving many participants, and the determination of foreign exchange benchmarks is based on actual business transactions; that is, not on mere estimates, as was the case for interbank transaction benchmarks and interest derivative benchmarks. However, the participants of the relevant transactions varied depending on the currency pairs. On the whole, four banks dominate the market for foreign exchange transactions, with a market share of more than 50% (UBS, Deutsche Bank, Citigroup, Barclays). The data submitted by those banks were collected by a service provider, which calculated an average value. Manipulations supposedly took place mostly in relation to currency pairs that were traded less frequently.

**2087.** A safeguard for the coordination existed in that the participants could be effectively deterred from deviating behaviour. For instance, deviating behaviour regarding the manipulation of interest rates during the financial crisis would increase the risk that individual banks' liquidity problems would become apparent. In addition, deviating behaviour came along with a loss of potential profits for the participating banks and traders.

**2088.** Further, the participants in the manipulations were able to effectively wall off their coordination against other market participants. To that end, they could make use of significant information asymmetries existing between the participants and outsiders. Regarding the benchmarks for interbank transactions and interest derivatives, detection was additionally hampered by the fact that, even within the banks, mostly only specialists understood and actively used the relevant information in financial products.

### ***Determination of reference rates required problematic information exchange***

**2089.** The determination of the relevant reference rates built upon an information exchange between the participating banks and undertakings, which based on the available information could raise competition concerns unless effective information barriers (Chinese walls) existed.<sup>902</sup>

**2090.** It is commonly accepted that the exchange of strategic information can raise competition concerns depending on the market conditions, the type of the exchanged information, and the type of the exchange. With regard to the market structure, such concerns are particularly likely to arise where the exchange – for the participants – takes place on transparent, concentrated, non-complex, stable, and symmetric markets.<sup>903</sup> The exchanged information can, by itself, raise competition concerns in particular where the information allows one to infer the identity of individual customers or suppliers as well as inferences concerning individual business transactions, thereby reducing strategic uncertainty regarding the competitors' future market behaviour (e.g., uncertainty regarding their pricing).<sup>904</sup> The

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<sup>902</sup> It is still unclear to what extent also explicit agreements existed with regard to individual financial products (e.g., currency options).

<sup>903</sup> European Commission, Guidelines on the applicability of Article 101 of the Treaty on the Functioning of the European Union to horizontal co-operation agreements (Guidelines on horizontal co-operation), OJ C 11, 14 January 2011, p. 1, para. 77. Note, however, also the reservation in para. 9, highlighting that the Guidelines on horizontal co-operation are not meant to provide guidance for the classification of the relevant agreements as "cartels".

<sup>904</sup> European Commission, Guidelines on horizontal co-operation, para. 86; see also OLG Düsseldorf, Decision

exchange must be assessed, among others, based on whether it takes place directly between the participants or through outsiders, whether it is public, and depending on how frequently it takes place.<sup>905</sup>

**2091.** The competition concerns raised through an exchange of strategic business information relate to the fact that the participating undertakings acquire similar expectations regarding market uncertainties, and thus restrain their independent market behaviour (restraint of hidden competition – *Geheimwettbewerb*)\*. In addition, the information exchange can allow the participating undertakings to actively stop deviating behaviour among themselves, and to wall off the market against competitive moves by other companies.<sup>906</sup>

**2092.** In the context of benchmark determination, the information exchange always happened within a problematic market structure. As noted, it took place between a few international commercial banks that were able to coordinate their behaviour without any corrective market force. In the cartel regarding the Euribor and Libor rates, moreover, the volume of the interbank market shrank substantially during the financial crisis. Therefore, only relatively few business transactions, often with a large business volume, could be used for the relevant interest rate submissions. This was an additional element that aggravated the effects of the manipulations.

**2093.** The data and the manipulation that were subject to the relevant traders coordination constituted extremely sensitive business information that was relevant for price calculations (price elements). In that respect, it did not matter that the determination of interbank and interest rate benchmarks was based on estimated values, and that the determination of reference rates for foreign exchange transactions rested on values derived from real business transactions.

**2094.** As stated above, the strategic value of the information regarding the reference rates for interbank transactions and interest derivatives resulted from the fact that the reference rates which the relevant service providers (e.g., Thomson Reuters) disseminate based on the bank submissions form a basis for multifarious financial products. The situation was similar with regard to the foreign exchange data.

**2095.** The strategic value of the manipulated foreign exchange information was additionally increased by the market situation in which the information exchange took place. Reference rates for foreign exchange transactions are determined as approximate values every half an hour or every hour. However, regarding such information, the daily rate fixing in London at 4pm is of particular importance, at which a closing value is determined which asset managers use to calculate the value of their investments in various currencies. Additionally, customers place orders for high-volume currency transactions frequently before or expressly for the time of the fixing in order to ensure the comparability of rates for their transactions. The closing value determined at the London fixing is particularly important at the change of the month as many funds managers execute hedging transactions only on the last trading day of the month in order to save costs and work. Traders could use the London fixing to manipulate exchange rates by placing many staggered orders on the market shortly before or after the reference point in time (“banging the close”), which was to their advantage at their own transactions. They could increase the effect on the reference rates by placing sham orders

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of 26 July 2002, VI-Kart 37/01 (V), Transportbeton Sachsen, para. 16 (citation: [www.justiz.nrw.de](http://www.justiz.nrw.de)); FCO, B2-19/08, Sector Inquiry Milk, Interim Report, September 2009, pp. 114-115; Final Report, January 2012; para. 142.

<sup>905</sup> European Commission, Guidelines on horizontal co-operation, paras. 90 ff.

\* The term “hidden competition” is here used to denote the German concept of competition without knowledge of the competitors’ moves. This concept is different from the concept of “obvious competition” in contrast to “hidden competition” (= other competitive forces).

<sup>906</sup> European Commission, Guidelines on horizontal co-operation, paras. 66-68.

which they cancelled after the reference moment (“painting the screen”). The exchange between the traders and concerted practices allowed them to coordinate such rate manipulation.

**2096.** According to official announcements and to the press, the exchange of the relevant information was organised in a way that it could influence the participants’ market behaviour allowing them to monitor and stabilise the concerted practices. For the exchange, the participants used chat rooms (“French Connection”, “The Bandits’ Club2”) that had been set up for multiple participants.<sup>907</sup> In addition, it seems that different forms of bilateral and/or circular information exchange existed. In the cartel concerning the reference rates for interbank transactions, the participants also used brokers as transmitters of manipulated information. The suspected cartel regarding reference rates for interest rate derivatives was a special case as the participating broker (ICAP) was itself the collection point for the banks’ rate submissions. Thus, the bank employees could order the broker directly to push the reference rate to a pre-defined level (the broker was therefore also labelled as “treasure island”).

**2097.** The exchange was fashioned in a way in the respective cases that extreme values were avoided such that coordinated submissions were not rejected (“remain within the pack”).

### *High organisational and behavioural standards were not observed enough*

**2098.** The aforementioned circumstances meant that the participating banks and undertakings had to meet high organisational and behavioural standards, the disregard of which created a high risk of a punishable concerted practice that distorted competition (cartel).

**2099.** These standards had to be met by the individual market participant. This, it was necessary that the information exchange necessary for the determination of the reference values was organised in a way that prevented relevant information from being accessible to the traders. The traders of competing banks were not allowed to exchange information among each other either. In addition, organisational arrangements had to be in place allowing for the monitoring of competitor contacts and for immediately taking counter-measures if impermissible concertation took place. Finally, it was and is necessary to further the compliance culture within the company actively (e.g., by means of training). Apparently, however, the internal control mechanisms of the cartel members were insufficient. According to the preliminary findings of BaFin in the Libor case, also at Deutsche Bank, “serious shortcomings and grave organisational deficits” could be identified.<sup>908</sup> A similar situation probably existed at other participating banks and undertakings because apparently even larger groups of employees there were able to take part in the anticompetitive practices without being sanctioned.<sup>909</sup>

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<sup>907</sup> CFTC, Orders of 19 December 2012, CFTC Docket No. 13-09 (re UBS); 27 June 2012, CFTC Docket No. 12-25 (re Barclays); 29 October 2013, CFTC Docket No. 14-02 (re Rabobank); 6 February 2013, CFTC Docket No. 13-14 (re RBS); 25 September 2013, CFTC Docket No. 13-38; DOJ (re ICAP); DOJ; Appendix (facts) to the Deferred Prosec. Agreement of 29 October 2013 (re Rabobank); Plea Agreement with RBS of 5 February 2013; Appendix (facts) to the Non-Prosec. Agreement of 18 December 2012 (re UBS); Complaint of 12 December 2012, U.S. v Hayes and Darin, 12 MAG 3229 (each in the Libor case).

<sup>908</sup> BaFin, as quoted in in: Hesse, Kultur des Wegsehens, [2014] Spiegel No. 2, 6 January 2014, p. 61; similarly no author, Streit zwischen Bafin und Deutscher Bank spitzt sich zu, Reuters/Handelsblatt, 7 January 2014; Jost, Bafin fordert mehr als nur Millionen-Strafen, Welt, 7 December 2013. Deficiencies also seem to exist in other divisions of the institution, e.g., regarding accounting, the prevention of corruption and money laundering, see no author, Behörden prüfen Bilanzmethoden deutscher Banken, Bloomberg/Handelsblatt, 9 August 2013; Clausen/Jost, Finanzaufsicht ermittelt gegen Deutsche Bank, Welt, 17 August 2013; no author, Ermittlungen gegen Deutsche-Bank-Mitarbeiter, Reuters/Handelsblatt, 9 September 2013.

<sup>909</sup> Cf. ArbG Frankfurt, Judgment of 11 September 2013, 9 Ca 1551 bis 1554/13 (not final). In the Libor cartel alone, at least 45 employees of UBS and at least 30 employees of Deutsche Bank are said to have participated; Bowers/Verstein, 7 Compliance Failures That Facilitated Libor Rigging, Law360, 17 January 2013; Stock/Kerkmann, Rabobank-Chef geht – Deutsche-Bank-Chef Jain bleibt, Handelsblatt, 29 October 2013.

**2100.** The standards to be met by the individual bank or the individual undertaking were further increased in the present cases inasmuch as the service companies and commissions responsible for determining the reference rates were clearly not monitoring the relevant procedures sufficiently. The monitoring by the responsible branch associations was denoted as unprofessional. The banks (and employees) participating in the manipulations were sometimes themselves represented in the monitoring committees of the associations that established the rules for determining the benchmarks.<sup>910</sup> The supervision by other market participants or the market authorities was likewise ineffective. The manipulations were partly even known to the market, but were apparently accepted practice.<sup>911</sup>

### *Investigation and conclusions*

**2101.** The identified manipulations are currently being investigated, which includes measures to remove the structural causes for the revealed manipulations. First, the incriminated banks and undertakings have themselves taken various measures, by withdrawing from the panels involved in manipulations, by improving compliance, by pursuing the participating employees through disciplinary actions, by prohibiting the use of chat rooms for the employees submitting to reference rate panels, and by tightening the conditions for the traders' private accounts. Several banks (e.g., Deutsche Bank) have – implicitly – acknowledged that the manipulations went beyond the misbehaviour of individual employees inasmuch as they have emphasised the importance of a company-wide “cultural change”.

**2102.** The organisation for the determination of the relevant reference rates has been improved as well. For example, regarding the reference rates for interbank transactions and interest derivatives, the responsibility for the necessary data collection has in a first move been transferred to another institution and is meant to be transformed in a second move from an index determination based on estimates to market-based determination.<sup>912</sup> If the suspicion of foreign exchange manipulations is confirmed, the group of players making submissions transactions for the foreign currency fixing could be broadened (e.g., transactions within half an hour instead of 60 seconds).<sup>913</sup> Further, the fixing could be transferred to a market-neutral (e.g., scientific) body to which trading platforms supply the transaction data. If such measures do not suffice, it may be necessary to revisit the decision to abolish the official foreign currency fixing.<sup>914</sup>

**2103.** The penalties imposed by the market and competition authorities have ended the previous toleration of the market manipulations. Additionally, the supervisory framework is reorganised, including a proposal for more stringent provisions on the determination and publication of reference rates and including more severe sanctions.<sup>915</sup> The respective regulatory changes, however, only relate

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<sup>910</sup> See Fellmann/Hug, Politiker fordern mehr Kontrolle, NZZ, 6 October 2013.

<sup>911</sup> Cf. Treanor/Rushe, Timothy Geithner and Mervyn King discussed Libor worries in 2008, Guardian, 13 July 2012; Hasan, Mervyn King ‘Not Interested’ In 2008 Libor Rate Warnings, Say Ex-BoE Colleagues, Huffington Post, 16 July 2012, as to the manipulation of the Libor benchmark; most recently Hippin, Bank of England unter Verdacht, Börsen-Zeitung, 13 February 2014.

<sup>912</sup> NYSE, NYSE Euronext Subsidiary to become new administrator of Libor, press release of 9 July 2013; Leising, ISDA überträgt Dollar-ISDAfix an Thomson Reuters von ICAP, Welt/Bloomberg, 27 January 2014.

<sup>913</sup> Taylor as quoted in Theurer, Tricks um vier Uhr nachmittags, FAZ, 22 November 2013.

<sup>914</sup> This proposal must be seen against the backdrop that currency trades have provided cartelisation incentives already repeatedly; see European Commission, Decision of 11 June 2002, COMP/36.571, Austrian banks (“Lombard Club”), OJ L 56, 24 February 2004, p. 1, on the European currency reform.

<sup>915</sup> Regulation 596/2014 on market abuse (market abuse regulation), OJ L 173, 12 June 2014, p. 1; Directive 2014/57/EU on criminal sanctions for market abuse (market abuse directive), OJ L 173, 12 June 2014, p. 179; Proposal of 18 September 2013 for a Regulation on indices used as benchmarks in financial instruments and financial contracts, COM/2013/0641 final; IOSCO, Principles for Financial Benchmarks, Final Report FR07/13, published on 17 July 2013. Due to the general loss of confidence, many banks have withdrawn from the Euribor panels anyway.

to capital market infringements, not to the accompanying competition infringements. The national legislator moreover introduced § 50c ARC already before the manipulations, thus creating a basis for the cooperation of and the information exchange between the market and competition authorities, thereby supporting the coordinated market supervision on the national level.

**2104.** In the Monopolies Commission's view, however, it is still doubtful whether the respective measures are sufficient. The number and the scope of the detected violations make it likely that competition-related manipulations might have taken place also in other areas. In any case, the Monopolies Commission advocates a permanently stricter supervision of the determination of reference rates, by both the market and the competition authorities.

**2105.** Moreover, in the Monopolies Commission's view, it raises great concerns that the German-language press reports with regard to the manipulations detected so far that all participants know that politicians would eventually not take any effective action.<sup>916</sup> This can potentially be explained not least by the fact that cartel infringements are considered in certain business circles to be trivial (though expensive) offences. The Monopolies Commission emphasises that the treatment of the manipulations can impair the confidence of the public in the competition-based market order in a lasting way. It recommends also reviewing the range of sanctions for cartel infringements as the fines imposed to date probably do not have a sufficiently deterrent effect – if viewed against the backdrop of the profits associated with the manipulations.<sup>917</sup>

### ***5.3 Other competition risks on the capital markets***

**2106.** For some time, also competition infringements in capital market trade have gained increasing relevance. The capital market trade has central importance for banks as well as for industry companies and even private investors. For instance, also the savings banks generate a significant part of their profits by investing customers' deposits on the capital markets, at least according to press reports.<sup>918</sup>

**2107.** For a long time, the application of the competition rules to capital market manipulations stood still in the background of the enforcement of capital market regulation, which should have captured those manipulative practices as well. That said, the competition rules can apply alongside, and may allow the authorities to take effective action also in borderline cases. As far as can be said, in particular the following cases may be relevant from a competition law perspective:

- Bid rigging in takeover cases (club bid rigging): Indications exist that financial investors can collude during takeovers to the detriment of the seller. In the United States, private equity investors have had to defend themselves in several cases against allegations that they had agreed that some investors should withdraw from the bidding process and take over the envisaged share after the successful bidder had been awarded the tender (at favourable conditions, as no takeover battle had taken place).<sup>919</sup>

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<sup>916</sup> Pointed Schieritz/Storn, ... und nichts dazugelernt, Zeit online, 12 December 2013; similar, however, also outside Germany, see B. Lallemand (Finance Watch) in: Auer, Lallemand: "Banken werden zur Manipulation angestiftet", Interview of the Austrian Die Presse, 15 August 2013.

<sup>917</sup> See already Monopolies Commission, XIXth Main Report 2010/2011, Strengthening Competition in Retailing and Services, Baden-Baden 2012, para. 477; and no author, Banken können EU-Strafen meist mühelos zahlen, FAZ, 4 December 2013 regarding the relevant issue; further already Chair Zimmer in an interview of Der Spiegel, Hesse, "Drakonische Strafen", [2013] Spiegel No. 50, 9 December 2013, p. 68 ("One should consider [...] tighter supervision and draconian sanctions also for the acting individuals" [*"Man sollte [...] an eine verschärfte Aufsicht und drakonische Strafen auch für die handelnden Personen denken"*])).

<sup>918</sup> Seibel, Banken haben Angst vor Google & Co., Die Welt, 24 June 2013.

<sup>919</sup> Pennsylvania Avenue Funds v. Edward J. Borey, et al., F. Supp. 2d, 2008 (W. D. Wash.); Dahl v. Bain Capital Partners LLC, et al. = Klein v. Bain Capital Partners LLC, et al., No. 07-12388, stage of proceedings: [http://www.gpo.gov/fdsys/pkg/USCOURTS-mad-1\\_07-cv-12388](http://www.gpo.gov/fdsys/pkg/USCOURTS-mad-1_07-cv-12388) ; see also Norcast S.ár.L v. Bradken

- Coordinated “creeping” takeovers: In several cases in Germany and the United States the allegation has been made in the past that strategic investors had colluded with banks to build up a hidden interest in order to circumvent reporting obligations and to secure the acquisition of the target undertaking.<sup>920</sup> The strategy of making a creeping acquisition was typically based in these cases on the acquisition of a long position within the framework of an options or swap transaction.<sup>921</sup> An investor can use such a swap transaction as a basis for coordinating with the banks holding the short position, which under the circumstances can be relevant under the cartel rules. The transparency obligations under securities law have been amended several times, though, in order to exclude the build-up of hidden investments in Germany.<sup>922</sup>
- Coordinating initial public offerings (IPOs) or exchange transactions: Coordinated manipulation of the exchange trade may in the individual case also give rise to liability under the cartel rules. This holds notably when, in the case of IPOs, stock market prices are manipulated to the detriment of the new shareholders. Also, it appears critical if the traders of several banks and undertakings coordinate by means of circular transactions, which are triggered by opposing orders about comparable trading volumes and for comparable prices, and which intended to create the false impression that a brisk market exists, in order to manipulate security prices (circular trading).<sup>923</sup> Dispersing and exploiting misleading information (“pump and dump”) by the employees of different undertakings should also have to be considered relevant under the cartel rules.
- Cornering or abusive squeezes: It has already been accepted for quite some time that, under the rules on the abuse of market power, also practices can be relevant from a competition law perspective where a market participant gains more or less complete control of the supply of or the demand for market instruments and, thus, is able to back the other market side into a corner.<sup>924</sup>

**2108.** It is still unclear to what extent manipulations relevant from a competition perspective actually take place on the capital markets. The limited number of publicly known complaints and the practice of the authorities seem to indicate that these are isolated cases. The fact that some of the practices that have become apparent in Germany were rampant according to traders, however, militates in favour of a rather meticulous supervision of the affected markets. In addition, the Monopolies Commission points again to § 50c ARC, which allows the German competition and market authorities to take a coordinated approach.

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Limited (No 2), [2013] FCA 235 (19. March 2013) (Australia).

<sup>920</sup> See, e.g., LG Hannover, 5 O 552/12 (pending); cf. no author Milliardenklage gegen Porsche landet vor Kartellgericht, Reuters, 19 June 2013; Zimmer, [2013] WuW 811.

<sup>921</sup> Regarding the details of such schemes, see Möritz, [2010] ZVGIRWiss, 94 (98).

<sup>922</sup> Most recently through § 25a WpHG, included by Gesetz zur Stärkung des Anlegerschutzes und Verbesserung der Funktionsfähigkeit des Kapitalmarkts (Anlegerschutz- und Funktionsverbesserungsgesetz) of 5 April 2011, BGBl. I No. 14, p. 538, in force as of 1 February 2012. Regarding potentially remaining loopholes, see Bückler/Petersen, [2013] ZGR 802 (819).

<sup>923</sup> Elliott, et al. v. CFTC, 202 F.3d 926 (7th Cir. 2000) (decided based on supervisory rules); Brammsen, [2012] WM 2134 (2138); in Germany, see recently Reimann, Banken treiben Börsenumsätze künstlich nach oben, WirtschaftsWoche, 17 June 2013 (where the coordination of several undertakings remains unclear, however). The presumed practices to influence noble metal prices might constitute a comparable issue.

<sup>924</sup> Cf. again LG Hannover, 5 O 552/12 (pending); and Fleischer/Bueren, [2013] ZIP 1253 for the details.

## 5.4 Abuse problems in payment transactions

**2109.** Competition problems with regard to payment transactions have occupied the European and German competition already for quite some time.<sup>925</sup> The Monopolies Commission has likewise analysed these problems repeatedly.<sup>926</sup>

### 5.4.1 Card and electronic payments

**2110.** In the past two years, the European Commission and the Federal Cartel Office have adopted a number of measures to solve competition problems regarding card payments and electronic payments:

- The European Commission has initiated new proceedings for the interbank fees charged by the credit card organisation MasterCard, and for several clauses and practices of the MasterCard system (concerning the cross-border acquiring, acceptance obligations). In parallel, the European Commission has already been analysing the conditions of the card organisation Visa for quite some time.<sup>927</sup>
- The European Commission in addition concluded proceedings concerning the standardisation of electronic payments via the Internet in summer 2013, and at the same time announced the continued supervision of the online payments market.<sup>928</sup>
- The Federal Cartel Office, after longer negotiations, has accepted the final commitments of the German Banking Industry, based on which the uniformly set dealer fees for EC (Electronic Cash) card transactions with personal identification number will be replaced by an individually negotiated service charge.<sup>929</sup> The acceptance obligation for EC cards (Honour all cards rule) was abolished.<sup>930</sup>
- The Federal Cartel Office has in addition investigated prohibitions imposed by banks to use the personal identification numbers PIN and TAN for direct payment transactions through non-bank service providers on the Internet. Further, the Federal Cartel Office has continued its actions against contractual clauses imposed by the banks, which impede the use of electronic direct debit (*Elektronisches Lastschriftverfahren* – ELV).

Concerning the regulation of card payment fees, a European Regulation failed to be adopted, for the present, only shortly before the European Parliament's term ended in May 2014.<sup>931</sup> Pursuant to it, the

<sup>925</sup> See, e.g., European Commission, COMP/34.579, MasterCard I; COMP/29.373, Visa International; COMP/37.860, Morgan Stanley Dean Witter/Visa; COMP/38606, Groupement des cartes bancaires “CB”; FCO, Activity Reports 1975, BT-Ds. 7/5390, p. 85; 1976, BT-Ds. 8/704, p. 92-93; 1979/80, BT-Ds. 9/565, p. 105; 1981/82, BT-Ds. 10/243, pp. 80 ff.; 1983/84, BT-Ds. 10/3350, pp. 109-110; 1987/88, BT-Ds. 11/4611, pp. 103-104; 1989/90, BT-Ds. 12/847, pp. 114-115; 1991/92, BT-Ds. 12/5200, p. 137; 1993/94, BT-Ds. 13/1660, pp. 137 ff.; 1995/96, BT-Ds. 13/7900, pp. 145-146.; 1999/2000, BT-Ds. 14/6300, pp. 167 ff.; 2001/02, BT-Ds. 15/1226, pp. 50, 212; 2003/04, BT-Ds. 15/5790, p. 171; 2005/06, BT-Ds. 16/5710, p. 159; 2007/08, BT-Ds. 16/13500, p. 138; 2009/10, BT-Ds. 17/6640, pp. 90-91; 2011/12, BT-Ds. 17/13675, pp. 82-83.

<sup>926</sup> Monopolies Commission, XIIIth Main Report 1998/1999, Competition Policy in Network Structures, Baden-Baden 2000, para. 78; XIVth Main Report 2000/2001, Competition in Networks through Regulation, Baden-Baden 2002, para. 646; XVIIIth Main Report 2008/2009, More Competition, Few Exceptions, Baden-Baden 2010, para. 619.

<sup>927</sup> European Commission, COMP/40.049, MasterCard II; COMP/39.398, Visa MIF.

<sup>928</sup> European Commission, COMP/39.876 – EPC online payments, Memo/13/553 of 13. June 2013.

<sup>929</sup> FCO, Decision of 8 April 2014, B4 – 9/11, cf. already press release of 28 May 2013.

<sup>930</sup> Fontaine (BdB), presentation: “Entgeltmodell für girocard”, German Banking Industry Committee information event of 9 September 2013.

<sup>931</sup> See Council, Information Note of 16 April 2014, 8031/14, on the Proposal for a regulation of the European Parliament and of the Council on interchange fees for card-based payment transactions, COM(2013) 550 final.

interbank fees for payments with credit cards should be limited to 0.3% of the turnover and the fees for payments with debit cards to 0.2% (or 7 cents).

**2111.** The demand for payment services is ultimately initiated by the customer of a dealer, who must ask for such services to be able to pay for the purchased goods. The payment transaction regularly involves three to four parties. Aside from the customer and the dealer, an organisation may be involved to process the payment transaction: otherwise this is done by the banks that manage the accounts of the parties.

**2112.** The payment by the customer can be initiated in various manners. In the event of a money transfer, the customer itself asks the bank to make the payment. In contrast, in the event of a direct debit transaction, the dealer initiates the payment, typically on the basis of a collection authorisation written out by the customer. In the event of card payment transactions, the customer or dealer initiates the payment of the customer's bank electronically.

**2113.** The different payment systems are platforms which are used to provide payment services on two-sided markets.<sup>932</sup> Especially card organisations create such platforms, in order to offer electronic payment services of various sorts.

**2114.** Payment systems are marked by network effects. A positive effect is that each dealer participating in the system increases the options for the bank customer to use the system. Conversely, each further bank customer using the system increases the attractiveness of the system for the dealers as well. A potential negative effect for competition consists in suction effects which emanate from the system due to the associated benefits and which increase the market entry barriers for competing systems. This aspect is particularly relevant in the Federal Cartel Office's proceedings concerning direct payment transactions and the impediment of electronic direct debit.

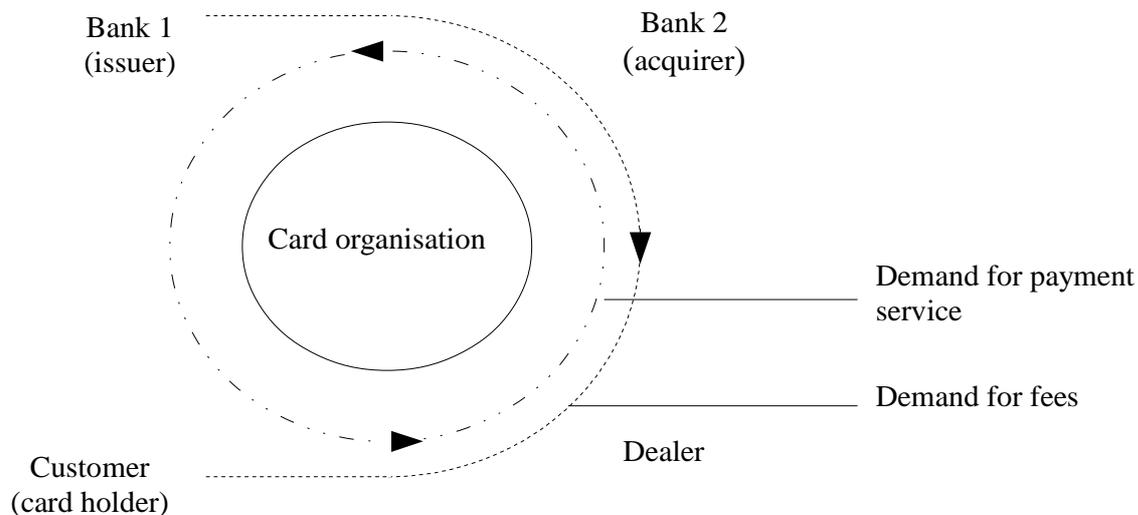
**2115.** Card payments are particularly difficult to assess from a competition law and competition economics perspective. In the event of a card payment, the payment is effected in the network of the card organisation. In that regard, a distinction is necessary, in the case of credit card payments, between systems where the card-issuing bank (issuer) and the bank accepting the dealer's claim (acquirer) are separate from each other (4-partner system) and systems where their functions fall together within the same card system (3-partner system).<sup>933</sup> At each step of the payment transaction, the party asking for the respective service may have incurred liability for fees.

**2116.** The demand for payment transactions is opposite to the demand for fees, which can be demonstrated – in a very simplified manner – using the example of a credit card payment transaction in the 4-partner system:

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<sup>932</sup> Monopolies Commission, XVIIIth Main Report 2008/2009, More Competition, Few Exceptions, Baden-Baden 2010, para. 619.

<sup>933</sup> In debit card transactions, it is true that the dealer likewise orders a bank to process the payment transaction, but the bank does not accept the dealer's claim like an acquirer but acts on the basis of a direct debit mandate; Koch in: Schimansky/Bunte/Lwowski, Bankrechts-Handbuch, Band I, 4th Ed. 2011, § 68 paras. 7 and 16.

**Figure VI.8: Business circuit in the case of credit card payments in the 4-partner system**

Source: own illustration.

**2117.** Among the usually payable fees, in particular the so-called interbank fees are controversial. By paying the interbank fee, the acquirer pays the issuer for contributing to the settlement of the dealer's payment claim. An interbank fee has to be paid in the 4-partner system, but not in the 3-partner system nor in the German EC debit card system or in the ELV.

**2118.** Positive and negative network effect also exist with regard to fees. The advocates of interbank fees consider it to be a positive effect that the issuer bank does not have to ask the bank customer to pay for the processing of the payment transaction because of the interbank fee. This enables the bank to issue cards at lower costs or even for free, which increases the attractiveness of the system. A negative effect is that the customers are potentially prevented from knowing the costs of the payment transaction. For the costs accruing at each step of the payment process are passed on to the customers to the extent that they do not have to be internalised within the chain. In that regard, the issuing banks profit from standing at the end of the chain, and from the customers' not knowing the costs which they are charged even though they are the contract partners of those banks. The dealers and the accepting banks, however, also accept excessive fees as they focus on the advantages associated with the card system and generally are able to pass on the accruing charges. The interbank fees, thus, establish a minimum price level for card payments, which the customers are not necessarily able to comprehend (*price floor*).<sup>934</sup>

**2119.** In addition, the contract stipulations of the card organisations contain clauses potentially restricting competition, which are meant to protect the attractiveness of the card system and to ensure permanently a sufficient participant base. According to those stipulations, the participating dealers are obliged to accept all cards with the logo of the card system, irrespective of the issuing bank (honour all cards). This ensures the problem-free use of the card, but the dealers must also accept the charges imposed by the issuing bank. In addition, the dealers are prohibited to adapt the product price vis-à-vis the customers according to the charges and fees that accrue in the payment system (non-discrimination rule). Consequently, it is impossible for the card users to comprehend the cost of the chosen payment system. The dealers pass on the costs of the different systems to all their customers.

**2120.** The competition authorities see the risk that the structural characteristics of the payments process are exploited to the detriment of bank customers. This applies also – and particular – in regard

<sup>934</sup> GC, Judgment of 24 May 2012, T-111/08, MasterCard, not yet officially reported, para. 143.

of interbank fees. That said, the experience with the abolition of such fees is ambiguous. According to such experience, it is likely that the issuing banks would attempt to compensate the abolition of interbank fees by raising the charges for card issuing and use, to the extent that this is possible under the market conditions. In the United States, the abolition of interbank charges (Durbin Amendment) has had the result that banks increased other fees or reduced or abolished previously non-paid account services.<sup>935</sup> The hope that the dealers, due to the competition, would pass on the reduction of their payment settlement costs to the customers was frustrated.

**2121.** The European Commission, with its proposal to cap the interbank fees, takes a middle course.<sup>936</sup> The statutory cap is meant to prevent only excessive fees. The fact that the cap is provided in a European Regulation can be justified by the fact that interbank fees also constitute entry barriers for banks on the acquiring side, and thus may contribute to the fragmentation of the single financial market (assuming that the acquirer has to internalise them). The cap, in contrast, can create additional possibilities to win more points of acceptance. An adequate level of fees, thus, may bring the interests of the intermediate banks as well as the interests of the card holders and dealers in line with each other. That being said, it is necessary that they do not bring about distortions of competition between the different card payment systems (especially to the detriment of the 3-partner system).

**2122.** However, the open question remains whether a fast development of the payments markets will not, anyway, reduce the competitive concerns on the authorities' side, or give rise to novel regulatory issues of a higher priority. For example, different suppliers of online payment systems and Internet firms have developed their own payment processing systems.<sup>937</sup> In addition, new types of payment systems have emerged outside the existing currency systems (e.g., bitcoin). The German consumers and companies, however, continue to prefer the established options to make payments. Hence, any changes are likely to happen only gradually and at individual payment services (e.g., with regard to money transfers) in the foreseeable future. The Monopolies Commission continues to monitor the development of the market.

### 5.4.2 Cash machine fees

**2123.** A structural competition problem also exists when consumers use cash machines in a situation where they cannot easily switch to other cash machines. The associated problem of the transaction fees accruing at cash machine transaction was already addressed in the XIXth Biennial Report, but will be dealt with a second time at this place in the right context.<sup>938</sup> The Federal Cartel Office is running an investigation in this area.<sup>939</sup>

**2124.** Where non-customers withdraw money from the cash machines of the savings and the cooperative banks, the fees charged for these withdrawals are not limited. In contrast, the private banks organised in the Association of German Banks (*Bankenverband*) have agreed on a maximum amount of EUR 1.95 for the fees. As regards debit cards, consumers complain frequently about relatively high fees for non-customer withdrawals. At the same time, regarding credit cards,

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<sup>935</sup> Jansen, Stopping the Spread of Bad Ideas, entry in: The Blog, Huffington Post, 5 November 2013; see critically Bott, Europäische Preisregulierung mittels Merchant Indifference Test scheitert an praktischer Umsetzbarkeit, study of August 2013, as to the EU approach of a cap on fees.

<sup>936</sup> As to the Proposal, see above para. 2110.

<sup>937</sup> Dapp/Stobbe/Wruuck, Die Zukunft des (mobilen) Zahlungsverkehrs, dbresearch of 5 February 2013; Seibel, Banken haben Angst vor Google & Co., Welt, 24 June 2013; no author, Banken fürchten "Paypal" & Co., dpa/Handelsblatt, 12 February 2013; Fehr, Zum Ausputzer degradiert, [2013] WirtschaftsWoche No. 47, 18 November 2013, p. 54.

<sup>938</sup> See Monopolies Commission, XIXth Main Report 2010/2011, Strengthening Competition in Retailing and Services, Baden-Baden 2012, paras. 594 ff.

<sup>939</sup> The FCO's investigation concerns particularly the contractual relations underlying the cash machine services (§ 1 ARC).

individual savings banks have even blocked their cash machines for non-customer withdrawals even completely in order to counter the excessive use, in their view, by direct bank customers.<sup>940</sup>

**2125.** It is an essential problem for the assessment of cash machine withdrawal fees and blockings that the payment by the cash machine is not an isolated service of the cash machine operator to the withdrawing cash machine user, but it is embedded in a network of contractual relations that does not reflect the economic supply-and-demand relations one by one. The savings banks and the cooperative banks are members of an organised debit or credit card system. On this basis, they offer cash withdrawals as an element of an account management contract and, as an isolated service towards non-customers. In the event of a non-customer withdrawal, from an economic perspective, they provide a distributory service to the account-managing bank as well as a direct service to its customers. In that context, the customer not only makes a demand decision by choosing the cash machine for the withdrawal, but it thereby also defines the demand of the bank managing its account.<sup>941</sup>

**2126.** The setting of cash machine fees and the blocking of machines must be assessed exclusively according to the economic demand relationships under competition law, and independent from the existing contractual obligations. At least in individual cases, it cannot be ruled out that the charged fees violate the market dominance rules. The relevant market for cash machine withdrawals must be defined from the non-customers' view according to the demand market concept. The savings and cooperative banks operating cash machines can be dominant in particular in rural areas as non-customers here are not, or not easily able to switch to cheaper cash machines. They can abuse this dominant position to charge excessive fees or to block their cash machines for non-customer cash withdrawals. The withdrawal fees are charged directly to the customer or towards the account-managing bank by way of an interbank fee; in the latter case, however, they are not or only partially absorbed and for the remainder charged to the customer. The cash machine agreement valid since 15 January 2011 stipulates that no interbank fee is charged for non-customer withdrawals from cash machines, but that the cash machine operators can charge the card holder directly for the withdrawal. This change, however, has not removed the problem of high cash machine fees in the essence.<sup>942</sup>

**2127.** It is, however, questionable whether and to what extent fees, which appear high to the customers in view of their individual cash machine withdrawals, are actually inadequate. The same holds with regard to cash machine blockings. When the savings and cooperative banks take such measures towards non-customers, they do so regularly to defend against other banks (e.g., direct banks) with whom they compete in the area of managing current accounts and which do not dispose of their own cash machine infrastructure (exclusionary abuse?). That said, they affect with these measures less their competitors directly and more the customers that can only withdraw money against high withdrawal fees or not at all (exploitative abuse?).

**2128.** Regarding a potentially abusive exclusion of the competitors, it is decisive that cash dispensing is not a service isolated from the account relationship, but that it is a distributory service executed within the framework of the account relationship. Outside the present context, it is accepted that an undertaking which is dominant upstream and vertically integrated is not allowed to harm competitors by providing a service to the competitors at excessive prices for distribution, while at the same time providing the same service at non-excessive prices through its downstream subsidiaries directly to the end-customers (margin squeeze). In the present context, it is less relevant whether the savings banks

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<sup>940</sup> Regarding blockings, see the cases references in Seiler, comment on LG Verden, Judgment of 15 December 2008, 10 O 102/08 (jurisPR-BKR 5/2009 Anm. 2).

<sup>941</sup> As stated correctly in: Immenga/Körber, K&R Beil. 1999, No. 1, 4 (5-6); Kapp/Rauhut, [2010] WM 1111 (1114).

<sup>942</sup> Nothing different follows from the finding of the Federal Ministry of Consumers in December 2012 that the level of fees at cash machines had overall dropped considerably.

and the cooperative banks are dominant upstream (account management), but more whether they dispose of the distributory infrastructure that is necessary in the individual case (cash machines). It is problematic in so far that they “penalise” non-customers at the cash machines for their account relationship with another bank. However, an abuse of dominance should only be assumed if proof exists that, by way of the charged fees, the cost of the possible free-riding of other banks are imposed on the non-customers without justification.<sup>943</sup> Cash machine blockings may violate the contractual stipulations of the card organisations or on the interbank level, but they can only be anticompetitive based on the principles of a refusal to supply.<sup>944</sup> In that respect, it must be taken into consideration that an account managing bank principally can install cash machines as well.

**2129.** Regarding a possible exploitation of the end-customers, it is doubtful in contrast whether the latter’s account relationship with another bank must be taken into account. According to the courts, the finding of a possible exploitation of a dominant undertaking’s customers is only based on the relationship between the cost of the concrete service of the undertaking and the price charged to the customer.<sup>945</sup> If the customers have the option to withdraw money only at discriminatory or otherwise inadequate conditions – if viewed in isolation – or not at all, it should thus be immaterial that the measure is used to create fair competitive conditions between the bank that operates the cash machine and the competitors of that bank in the area of account management.

**2130.** The Monopolies Commission abstains in this Report from an in-depth analysis of these case-specific issues, the more so as additional questions arise concerning the compatibility of the agreements underlying the cash machine services with the cartel prohibition (§ 1 ARC). In that respect, the Monopolies Commission points to the Federal Cartel Office’s investigation. In its view, however, the problems of cash machine withdrawals confirm the fundamental necessity of further improving the transparency regarding costs and fees for consumers. It appears necessary as a first measure that the consumers are informed prior to the cash machine withdrawal from an alien bank of potentially accruing high withdrawal fees, which is still not ensured in all cases. Further, consumers should be pointed to potentially arising high non-customer withdrawal charges already when they open an account. The statutory initiative of the EU to improve the transparency of fees appears helpful also in the present context. The occasionally discussed statutory cap on cash machine fees, however, would make investments in the cash machine infrastructure in rarely frequented locations unattractive and at least at present does not appear necessary.

## ***5.5 Competition and consumer protection***

**2131.** Issues of investor and consumer protection vis-à-vis financial service providers (consumer protection) can imply a competition policy component. This applies at least if, and in so far as, potential consumer protection problems can be traced back to competition distortions that are to the detriment of individual consumers or of consumers as the “opposite market side”. Such distortions of competition can follow from the conduct of individual market participants (e.g., banks), but they can

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<sup>943</sup> Cf. European Commission Communication, Guidance on the Commission’s enforcement priorities in applying Article 82 of the EC Treaty to abusive exclusionary conduct by dominant undertakings (Communication on exclusionary abuse), OJ C 45, 24 February 2009, p. 7, paras. 77, 39 ff.; European Commission, Decision of 17 October 2007, COMP/38.806, Groupement de cartes bancaires “CB”, paras. 208-213, 236 ff.; paras. 388, 428 ff., especially paras. 469-470.

<sup>944</sup> Cf. European Commission, Communication on exclusionary abuse, para. 81.

<sup>945</sup> ECJ, Judgment of 14 February 1978, 27/76, United Brands, [1978] E.C.R. 207, para. 251 (relevance of the cost of only producing the supplied product); see also ECJ, Judgment of 11 November 1986, 226/84, British Leyland, [1986] E.C.R. 3263, para. 30; European Commission, Decision of 9 December 2009, COMP/38.636, RAMBUS, para. 66 (required relationship between the amount of payment and the value of the paid product); in German law, see most recently BGH, Decision of 15 May 2012, KVR 51/11, Wasserpreise Calw.

also have a structural origin (e.g., taxes that are not product-neutral, market opacity).<sup>946</sup> There is probably, however, no purchase for competition policy instruments where financial service providers exploit a superior position that results from a lack of competition (market failure) or the individual negotiating power following from an existing contract or the bank customer's need, but not from a distortion of competition (e.g., the pressing need to obtain additional credit). Consequently, the possibility of many well-known consumer protection problems through competition policy appears doubtful.<sup>947</sup>

**2132.** From a competition policy perspective, however, it should be the aim of consumer protection to make consumers able to effectively occupy their role as independent market participants. Thus, it is problematic to observe that consumers abstain from changing suppliers (e.g., through changing accounts), contrary to what one would generally expect under normal competitive conditions, in view of the fact that they can barely cope with the complexity of financial business relations. Likewise, the comprehensive and indispensable product information obligations appear questionable, the ramifications of which have been criticised by banks and consumer associations.<sup>948</sup> In contrast, it seems to be of high priority that the transparency of the cost borne by consumers (e.g., credit cost) and the payable charges and fees is improved,

**2133.** The Monopolies Commission therefore welcomes, from a competition policy perspective, the EU measures to simplify account changes and to improve the comparability of account fees and the cost transparency regarding financial investments.<sup>949</sup> In view of the criticism voiced to it, the Monopolies Commission moreover suggests that the consumer protection measures regarding financial advice be fundamentally reviewed against the backdrop of the Regulation on basic information sheets for investment products.

## ***5.6 Implicit guarantees for financial products***

**2134.** Indications exist that implicit State guarantees exist not only for banks and other market participants, but also for financial products. Such a guarantee may arise if confidence in certain products receives protection because a loss of confidence has potentially systemic implications, which cannot be accepted. The products consequently enjoy a competitive advantage vis-à-vis competing products in which confidence is not equally protected.

**2135.** The risk of distortions of competition due to implicit guarantees is prevalent with regard to refinancing products such as bonds and asset-backed securities. Those refinancing products have different risk structures, which makes them attractive for different investors. Hence, they probably

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<sup>946</sup> Cf. FCO, Activity Report 1976, BT-Ds. 8/704, pp. 91-92. According to the consumer protection associations, tax-related distortions of competition exist particularly with regard to pension products, which are sometimes also not made available to certain professions (e.g., independents).

<sup>947</sup> This concerns, particularly, the barriers for consumers to basic financial products (e.g., current accounts, consumer loans), the excessive loan charges criticised by consumer protection associations, and the fact that not needed additional services are forced on the consumers (e.g., credit default insurance). A similar problem seems to exist with respect to excessive conditions for overdraft loans as overdraft loans are no independent product available on the market, but they are only requested within the framework of an existing account relationship (lock-in).

<sup>948</sup> See also above, para. 1706.

<sup>949</sup> Council, Information Note of 22 April 2014, 8323/14, on the legislative resolution of the European Parliament of 15 April 2014 on the Proposal for a directive on the transparency and comparability of payment account fees, payment account switching and access to a basic payment account, COM(2013) 266; Information Note of 16 April 2014, 8486/14, on the Proposal for a regulation on a new Key Information Document for investment products, COM(2012)0352.

only partially compete with each other directly.<sup>950</sup> An implicit State guarantee may exist in particular with regard to the following financial products:

- *Pfandbriefe* and comparable covered bonds, as well as
- Sovereign bonds issued by EU Member States and other bonds issued for the purpose of financing public services (e.g., municipal bonds).

The implicit guarantees for such products, however, have a differing impact on competition.

### 5.6.1 *Pfandbriefe and comparable covered bonds*

**2136.** Indications exist that an implicit guarantee exists for the benefit of *Pfandbriefe* and comparable covered bonds. A *Pfandbrief* is a German instrument securitising a mortgage loan which the *Pfandbrief* issuer has acquired and which is guaranteed through a mortgage. *Pfandbrief* issuance is subject to special rules. In particular, mortgages and land charges may be used only up to 60% of the collateral value in order to cover the obligation underlying the *Pfandbrief*.<sup>951</sup> Other collateral is subject to even more stringent restrictions.<sup>952</sup> German *Pfandbriefe*, thus, have a reputation of being particularly safe, also in comparison with similar products in other Member States.

**2137.** Their high security makes the investment in *Pfandbriefe* relatively safe. Nonetheless, the way these financial instruments are structured is not without problems. Risks regarding investor confidence can arise if the value of collateral dwindles in the course of a crisis (e.g., a mortgage crisis), and also if the issuer risks failing, independently of the *Pfandbrief* business, for instance, due to refinancing problems (as was the case for HRE). Since it is of crucial importance that the issuer is able to honour the issuance, the collateral is even less important for the investors than the issuer's financial strength.<sup>953</sup>

**2138.** The security of *Pfandbriefe* and comparable foreign financial products is guaranteed by the State. Therefore, the performance of those products is influenced by the respective State's CDS spreads. Hence, German *Pfandbriefe* currently benefit from a competitive advantage vis-à-vis foreign products without that advantage being justified by the quality of the *Pfandbriefe*.<sup>954</sup>

**2139.** Covered bonds, however also have a competitive advantage if compared with other refinancing products such as asset-backed securities (particularly RMBS<sup>955</sup>). In that regard, it has been noted before that asset-backed securities can fulfil similar functions to covered bonds, but that they make it possible to use additional collateral because they allow for the collateralisation of different and otherwise not marketable (= illiquid) risks. Market participants see the competitive advantage of covered bonds in the fact that asset-backed securities are treated more harshly from a regulatory perspective or as repo collateral as compared to covered bonds.<sup>956</sup>

<sup>950</sup> The actual market delineation between bonds and ABS is still open, as is the market delineation for various bond products; European Commission, Decision of 28 September 2007, COMP/M.4860, HRE/DEPFA, paras. 8-9; Decision of 1 February 2012, COMP/M.6166, Deutsche Börse/NYSE Euronext, para. 83; Decision of 24 June 2013, COMP/M.6873, Intercontinental Exchange/NYSE Euronext, para. 129.

<sup>951</sup> §§ 14, 18 PfandBG.

<sup>952</sup> § 19 PfandBG. Moreover, see Federal Government, Reply of 21 July 2009 on the Minor Enquiry of Deputies Dautzenberg, et al., BT-Ds. 16/13823, on the other statutory advantages of *Pfandbriefe* (particularly, in the case of the *Pfandbrief* issuer's bankruptcy).

<sup>953</sup> Therefore, the value of the *Pfandbrief* follows largely the development of the spreads of the issuing bank; cf. Frühauf, Die Hypothek der Hypo Real Estate, FAZ, 13 May 2009, in the context of the financial crisis.

<sup>954</sup> At the same time, however, the German *Pfandbrief* also is also exposed to potential distortions of competition because foreign products can benefit from regulatory advantages at significantly lower cost.

<sup>955</sup> RMBS = Residential Mortgage Backed Securities.

<sup>956</sup> See para. 1750 above; cf. Aufsatz/Bayer/Teuschert, [2012] ZfgK 923 (926).

**2140.** The Monopolies Commission recommends that regulation be reviewed as regards privileges that *Pfandbriefe* enjoy as refinancing tools merely because they benefit from an implicit guarantee. In contrast, the regulatory disadvantages for asset-backed securities should be removed unless they are demonstrably justified.<sup>957</sup>

### ***5.6.2 Sovereign bonds and other bonds issued for the purpose of financing public services***

**2141.** The State finances public services, among others, by issuing bonds on its own account. In the course of the euro and sovereign debt crisis, the acquisition of large sovereign bond portfolios through banks has gained considerable market significance and also become an acute political issue. Other bonds used for public financing purposes are not in the spotlight cast by these developments (e.g., municipal bonds). From a competition perspective, a distinction must be drawn between the issuance (primary market) and the trade in State-issued bonds (secondary market).

**2142.** As concerns the bond issuance, it is unclear whether it constitutes an entrepreneurial activity. According to European jurisprudence, the demand for a product cannot be separated from its later use, and consequently the economic or non-economic character of the use also determines the character of its acquisition.<sup>958</sup> That jurisprudence may apply to the issuance of public bonds. The bond issuance is a form of borrowing for the purpose of obtaining the funds to fulfil public service obligations. The bonds only securitise the loan. This may militate against viewing the issuance of public bonds as an entrepreneurial activity.<sup>959</sup>

**2143.** However, bonds issued by public bodies are also traded on the secondary market. In that case, they compete directly with each other and possibly also with corporate bonds. In order to protect the increased confidence in public bonds, however, rules exist that guarantee the equal treatment of the bonds sold by different public issuers (irrespective of their creditworthiness) and provide for a better treatment of such bonds in comparison with corporate bonds. This raises the question whether bonds of public issuers enjoy a competitive advantage and, in particular, from an implicit guarantee that favours directly the bonds and indirectly the banks that are highly invested in such bonds.

**2144.** At the present time, such a competitive advantage probably exists at least for sovereign bonds.<sup>960</sup> In competition with other financial products, sovereign bonds benefit first from regulatory advantages. According to market participants, the schematic risk weight applying to sovereign bonds, for instance, can be significantly lower than the actual risk associated with such bonds.<sup>961</sup> In addition, sovereign bonds are generally treated as highly liquid assets (level-1 assets).<sup>962</sup> Along with these advantages comes an implicit guarantee due to the perception that failing Member States are saved by other Member States within the euro system. It is the general view that these competitive advantages of sovereign bonds reduce the European banks' willingness to finance companies, and make them finance the Member States instead. The decision to consider sovereign bonds in the current asset and balance sheet review with their actual risk weight, at least partially, does not change the finding that those bonds have a competitive advantage in trade and that investors consequently prefer to buy them.

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<sup>957</sup> See Erber, [2011] DIW Wochenbericht No. 35, p. 3 (5), and No. 43/2008, 668 (669, 672) (mutual dependency of the pooled risks, funding through ABCP on the overnight money market).

<sup>958</sup> ECJ, Judgment of 11 July 2006, C-205/03 P, FENIN, [2006] E.C.R. I-6295, para. 26.

<sup>959</sup> It has not been decided so far whether the same holds conversely where the central banks acquire State sovereign bonds for purposes of monetary policy.

<sup>960</sup> In the context, competition questions in relation to monetary policy, as it is made necessary by the Euro crisis, shall again not be taken into consideration (e.g., a potential guarantee effect of the ECB's OMT programme). As to the ECB's approach, see the pending case BVerfG, 2 BvR 2728-2731/13; ECJ, C-62/14, Peter Gauweiler, et al.

<sup>961</sup> Articles 114 ff. of Regulation 575/2013, § 12 SolvV.

<sup>962</sup> Articles 416 of Regulation 575/2013.

**2145.** Other bonds issued for public financing purposes benefit from similar, but regularly less far-reaching privileges.<sup>963</sup> The attractiveness of such bonds, however, often suffers from insufficient available information and a lack of ratings.<sup>964</sup>

**2146.** The regulatory privileges for public bonds may have been justified at the time that the single currency was created. From a competition perspective, there is nowadays nonetheless reason to call for higher risk transparency and a reduction of schematic privileges for public bonds. The Monopolies Commission joins the government and the Federal Bank in the position that they take in that regard.

## ***6 Summary: fundamental propositions and recommendations***

- In the short term, the financial crisis made substantial sovereign measures necessary to stabilise the financial system. After this aim has been reached, it is necessary to develop a balanced policy approach, taking into account aspects of both financial stability and of undistorted competition. This special chapter includes recommendations that are to the point in that regard.
- The financial crisis demonstrated that implicit guarantees provide financial market participants with a systemic advantage in competition. The State aid proceedings concerning bank rescue measures could take account of this aspect only to a limited extent. The Monopolies Commission advocates the speedy restitution of State aid by the institutions that have obtained such aid and still benefit from it.
- The creation of a banking union is the right answer to the financial crisis and, from a competition policy perspective, must be geared towards three objectives: the neutralisation of existing implicit guarantees (in particular through the Single Resolution Mechanism), hindering the build-up of new implicit guarantees (in particular through capital requirements), and the increase of market transparency to identify such guarantees. The banking union will, however, only achieve these objectives if public discretion regarding an exemption from liability for individual market participants is reduced to a minimum, if the market participants build up sufficiently capitalised funding sources, and if regulation is the least complex as is possible. The Monopolies Commission considers additional efforts to be necessary in that respect.
- It remains to be observed to what extent the present regulation will reduce implicit guarantees for banks. The further evolution of that regulation will in any event have to take account of shadow banking activities, based on a flexible approach.
- The future revisions of the financial market regulation should be oriented at three guideposts, i.e., the avoidance and reduction of competition restraints through an unbalanced regulatory burden, the protection of German and European market participants' competitiveness, and the need to counterbalance the ongoing fragmentation of the financial markets.
- The German banking system has a stable structure due to its three-pillar composition. That cannot belie the perception, though, that it is interspersed with a multitude of structural distortions of competition – often emerging over a long period. The Monopolies Commission speaks out in favour of a review of the competitive situation by the competition agencies, and the removal of the identified distortions of competition.

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<sup>963</sup> Articles 115 of Regulation 575/2013.

<sup>964</sup> Specifically in relation to municipal bonds, see Friedrich/Walkshäusl/Lesser, Die Bepreisung von deutschen Kommunalanleihen, Studie der Kandler-Gruppe (23 January 2014); accessible: [http://www.kandler-gruppe.de/files/20140123\\_die\\_bepreisung\\_von\\_deutschen\\_kommunalanleihen\\_-\\_the\\_pricing\\_of\\_german\\_municipal\\_bonds.pdf](http://www.kandler-gruppe.de/files/20140123_die_bepreisung_von_deutschen_kommunalanleihen_-_the_pricing_of_german_municipal_bonds.pdf).

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- The proceedings against large commercial banks and other undertakings due to the manipulation of reference rates, and certain developments of capital market trade militate, in the Monopolies Commission's view, in favour of a stronger enforcement of the competition rules on those markets.
  - With regard to competition problems in the payments service sector and consumer protection as concerns financial services, the Monopolies Commission advocates a further improvement of cost transparency for the consumers.
  - Regulation should be reviewed with a view to removing privileges for individual financial products stemming from an implicit guarantee – as opposed to genuine advantages of those products (in particular, sovereign bonds, covered bonds).